

## Financial scandals: An ongoing reality

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### Abstract

The large corporates have emerged and have grown with the public investing their funds and placing confidence on the growth prospects of the firms. The big corporate houses at times misuse this trust placed on them by the investors and play around with their money without realising the possible after effects that might follow and tarnish their image. Since the inception, the corporate scandals have been continuously happening, and the more the compliances, rules and regulations are built, the more and fancy loopholes are emerging from time to time. The acts and regulations like Sarbanes-Oxley Act in US, Companies Act in India are the steps taken to mitigate these frauds. Apart from rules and regulations formed, there is a dire need to build the sense of belongingness and drive ethical behaviour within the internal management of the company to prevent these frauds. In this paper we will be focusing on "Why do Corporate Frauds happen and what is common in those frauds?"

**Keywords:** scandal, corporate frauds, sarbanes oxley act, companies act, ethical behaviour, loopholes

### Introduction

Fraud: A Fraud is any activity which involves gaining at the cost of others' loss by the way of unlawful and unethical means. Corporate Fraud/Scam involves gaining advantage by any of the modes given below:

1. Deliberate Misrepresentation or Concealing of Financial Information which affects or will affect the Stakeholders' interest.
2. Any Misappropriation of Assets of the Organization and misuse of the same.
3. Abusing the Fiduciary Relationship (Especially in case of the Key Managerial Personnel.)
4. Over stating the Financial Statements to attract public funds.

### Why do people commit frauds?

For answering this question, various studies have been performed; one of them is the famous Fraud Triangle. The Fraud Triangle explains three essential factors which are very commonly present where there is any fraudulent activity involved. A person becomes a fraudster when the three factors namely: pressure, opportunity and rationalization, are involved. In each case of fraud, the outcome is deceit, which harms the investors and public, but how do frauds begin and what motivates the person to commit the fraud is the main question.

### Fraud Triangle

According to the speech given by Lori Richards, Director, Office of Compliance Inspections and Examinations Securities and Exchange Commission, there are three factors that must exist for a normal person to become a fraudster and commit a fraud: Pressure i.e. financial need, reaching at the top by any means, avoiding embarrassment or loss of status; Opportunity i.e. weak internal management, the public posing good confidence in the corporate and the entrepreneur and there is a perceived low risk of detection of fraud due to its good image in front of public; and Rationalization i.e. the ability to avoid

feeling guilty by providing reasons that are reasonable and justifiable for committing any such act that may be called as a fraud. (Richards, 2008) [5].

The above said fraud triangle involves Pressure, Opportunity and Rationalisation as factors to commit a fraud. The Pressure is any form of act, situation or contingency which force a person to attempt the unethical and unlawful act. This pressure can be in the form of Financial Need, Peer Pressure, Pressure by Management like loss of jobs or demotion. Sometimes internal motivation like greed, disrespect towards employer, Govt. or any other agency also pressurise the person to commit fraud. This is an internal pressure. However the former one was External Pressure to commit fraud. Opportunity is nothing but, availability of a chance to not being caught. A weak Internal Control System can be a perfect example of opportunity for a fraudster. Rationalisation is a justification towards oneself to commit the fraud. For example taking a loan and not paying back with the justification that I am not making much loss to the person. The individual explain and justifies himself about his dishonest act.

### Objective of the Study

The paper aims to analyse the commonness in the frauds and what motivates the big corporations to commit frauds. This paper also throws a light on good governance, ethical behaviour as compared to corporate governance and various initiatives taken by the government by formulating rules and laws in reducing the occurrence of such fraudulent activities.

### Research Methodology

The secondary data from various journals, newspaper articles and government sites is taken for the research purpose.

### Corporate Scams: An Ongoing Reality

With the new time zone frauds have also become more frequent and severe. Today frauds have become an ongoing reality which runs on a parallel line along with the corporate world. Cases like Enron, Tyco, Satyam and many more have shown

that with the advancement of laws & corporate governance scams have also found its ways and means. Now to know more about the reasons why do scams actually happen and who all are involved in those frauds let us go through the different scams in the recent history.

From 1998 to 2009, major scams surrounded the financial world. (sec.gov.in) (washingtonpost.com, 2005) (investopedia.com) [1].

**Table 1:** showing core facts of the Scams.

Name of the Company	Quantum of wealth involved.	Main Fraudsters and their Designation	What actually happened	How scam got Caught	Auditors involvement
<b>Waste Management Co. Ltd</b> 1998, U.S.	\$1.7 Bn. inflated profit and more than \$6 Bn. of Investors wealth was affected.	CEO cum Dean, L. Buntrock. And other KMP.	1. Less Depreciation Charged on their Assets (By using Higher Salvage Value and Longer useful life). 2. Refused to record expenses 3. Expenses were Capitalised to inflate the Profit figures.	They caught up when a new CEO took over the position and reviewed the books of accounts	Yes, Auditor Arthur Anderson.
<b>Enron</b> 2001, U.S.	Investors lost nearly \$ 11 Bn, when stock price of the co. declined from \$84.87 in 2000 end to \$1 in Nov 2001. It led to huge job losses.	CEO Kenneth Lay and CFO and CEO Jeff Skilling	1. Booking of Entire Sales as Revenue under Mark to Market Accounting 2. Special Purpose Entities were used to dodge the accounts.	Insider Whistle Blower named Sherron Watkins raised the concerned second time.	Arthur Andersen was found guilty for illegally destroying documents required for SEC's investigation.
<b>Worldcom</b> now known as MCI 2002, U.S.	Internal audit showed that co. improperly accounted for \$3.8 bn in operating expenses over 5 quarters. 17,000 worked were laid off.	CEO Bernard Ebbers CFO Scott Sullivan	1. Under-reporting of 'Line-Cost' and capitalised them to show falsified growth 2. Values of assets were inflated. 3. \$3.8 Bn. Operating expenses were improperly accounted.	The concern was raised by the internal audit dept. of the company when they noticed around \$3.8 Bn. Operating expenses were accounted in an invalid way.	Not directly, but Auditor firm Arthur Anderson failed to detect the fraud timely.
<b>Tyco International</b> 2002, New Jersey	Unauthorised sale of 75 Mn. stocks of the co. amounting \$450 Mn.	CEO L. Dennis Kozlowski and CFO Mark Swartz	The Greedy CEO Kozlowski along with CFO Mark Swartz acquired low or no interest loan from the organisation without the approval of Shareholders and sold stocks of the co. These funds were then smuggled out on the name of executive bonus and benefits.	The matter come into notice when the stock prices suddenly plunged nearly by 80% within 6 weeks during early 2002. SEC afterwards questioned the accounting practises of the co. and the Loan taken by Kozlowski.	The Auditor firm PwC was getting high remuneration for its services like auditing of accounts and tax consultancy. The Auditor firm certified all the financial statements of the company.
<b>Health South</b> 2003, U.S.	The Co. exaggerated the revenues to the extent of \$1.4 Bn.	CEO Cum Founder Richard Scrusby	The CEO cum Founder Richard using his power forced its employees to inflate the profit and revenue figures.	The first instance when this forged accounting practice come into notice was, when Richard in 2002, sold Health South Shares worth \$75 Mn. Just before the company posted a huge loss.	Its not clear whether the Auditor EnY was involved with the fraudsters or not but it is sure that the Auditor failed to perform its duties towards the shareholders' interest.
<b>AIG</b> 2005, U.S.	It made about \$ 4.3 Bn worth of accounting errors.	CEO Hank Greenberg	The Company forged its books of accounts by improper accounting of huge Reinsurance Transactions. 2. Booked loans as Revenue. 3. The company with the motive of inflating its net worth made delays in annual 10-K Filling.	The fraud was revealed by the regular investigation conducted by the SEC.	The 'auditor PWC LLP, couldn't performs its duties duly.
<b>Lehman Brothers</b> 2005, U.S.	Around \$50 Bn. Loans were disguised as sales. With \$639Bn. in Assets and \$619 Bn. in liabilities Lehman's bankruptcy was the largest on world.	Lehman Brothers' Executives and Auditor of the firm; EnY	Traded in Sub-prime assets and assumed that they will be bought back in future. The down turn of this company is one of the reasons to the House hold Bubble burst in US Financial Market.	They were caught when they sunk into huge debts, hence leading to bankruptcy.	Auditor EnY was allegedly involved in the scandal.
<b>Satyam</b> 2009, INDIA	Satyam overstated its Cash Reserves of Rs. 5040 Cr. which did not exist. Understated Liabilities of Rs. 1230 Cr.	CEO Ramalinga Raju and his brother Rama Raju.	Same Story was followed by Ramlinga Raju. The books of accounts were overstated and he inflated the profit figures to attract public funds. The Raju & his family held nearly 25% of the stake in the company as promoters, which they sold before collapse of the co. and raised cash amounting to Rs. 3029 Cr.	The CEO Rama Raju Confessed the scandal on Jan. 7, 2009.	Had the auditor performed its regular audit as per reqd. accounting standards it might have the saved thousands of peoples' money and jobs.

### What's So Common In These Uncommon Frauds?

Among all the above Scams it is observed that in all the cases, Fraudulent Financial Reporting was supported and initiated at the Top Level Management along with the corrupt Auditors. The scams are generally cooked up either by Chief Executive Officer, Promoter, Chief Finance Officer or any of such Key Managerial Personnel. Even though these scams were placed in different time zones within the same decades they shared the same modus operandi. The Following are the observations in the above said scams -

Every shell game starts with Cooking of Books of Accounts by either of following ways:

1. Undervaluation of expenses or Capitalisation of huge losses and expenses.
2. Overstating Assets to show strong Proprietary Ratio to attract public funds.
3. Showing Huge Debts as Partnership.
4. Booking of Loans as Revenue to exaggerate the profit figures.
5. Lowering Depreciation charge which in return increase the profit as well as exaggerate the value of underlying assets.
6. Faulty or improper accounting practises such as Mark to Market accounting in case of Enron.
7. The Scam is initiated at Top Management and further forcefully implemented at lower levels.

### Now The Question Arises What Needs Be Done To Prevent These Unwanted Scams!

To prevent, first the root cause of the problem must be identified: The problem of scandals exist within the organisation. It is not injected from outside, it emerges from inside the organisation. One of the common reasons why these fraudulent activities emerge as big scandals is the weak Internal Control System. There are as many such reasons due to which small frauds transform into a big scam and eat up the investors' wealth. Some of the common reasons behind these stories are:

1. CEO/CFO with huge share-holding in the company.  
Weak Internal Control Measures
2. Greedy and Dishonest top officials.
3. High Compensation to CEO and other KMP.
4. Failure of External Auditors in performing their roles.
5. Lack of Audit committee.
6. Lack of confidence in Whistle Blower.

To prevent these frauds "*Good Governance*" is one of the Solutions.

### Importance of Corporate Governance in preventing corporate scams

Corporate Governance is the system by which an organisation is managed and controlled keeping in mind internal and external environment in such a way that that it monitors the actions of management to mitigate the possibilities of any unfair and unlawful conduct by its' officials. Corporate Governance defines the ways, decisions are formulated and implemented as a whole, it decides how the whole organisation is to be governed, operated and controlled. Corporate Governance is different from Management. The Management is concerned more about the profits and incomes of the company, whereas the Corporate Governance focus on decision making accountability, control and behaviour of the top level management within the organisation. SEBI, The

Securities and Exchange Board of India, explains Corporate Governance as "Commitment of Management to perform organisation's goals and objectives as a Trustee of Shareholders". (Agarwal & Medury, 2013) [3].

### How Corporate Governance Helps In Preventing Frauds

Corporate Governance ensures the fairness, transparency, accountability and responsibility of the management towards other stakeholders. It also raises the accountability of Account Officers, Auditors and Key Managerial Personnel for the financial transactions involved. A Strong Governance structure protects the interest of shareholders. Following are the ways to build up a strong Corporate Governance Mechanism within the organisation:

- a. Strong Internal Control Measure.
- b. Formulating Audit Committee and updating the same with new laws0.
- c. A Confidential and Strong Whistle Blower Mechanism.
- d. Keeping Close eye on officials with secret information to prevent Insider Trading.
- e. Balanced equation of Non-independent and Independent Directors.

All the above ways help in creating a strong and fair governance policy which in turn helps in minimising the possibilities of the occurrence of fraudulent activities. These ways reduce the risk of mismanagement and corrupt practises that dodge the public funds.

### Good Governance- A Better Perspective than Corporate Governance.

Now-a-days, we can find that the term Good Governance is more frequently used in corporate world than Corporate Governance. Good Governance or Good Corporate Governance is more deep rooted than the Corporate Governance. A Good Corporate Governance is not just compliance of laws and legal requirements, but it is ensuring clean and fair accounting practises, a balanced business model which incorporates the needs and interests of all the stakeholders of an organisation. A Good Corporate Governance is not limited to management and shareholders' interest but it takes care of many other essential parties related to the business like, suppliers, customers, investors, and creditors, debtors, generally known as other stakeholders.

On Good Governance, one of the paper of United Nations Economic and social Commission for Asia and Pacific remarks that Good Governance has eight major features. These are: responsive, participatory, accountable, consensus oriented, transparent, effective and efficient, follows the rule of law and is equitable and inclusive. It also ensures that corruption is reduced to lowest possible level, the views of the minorities are taken into consideration and the vulnerable voices in the society are heard and given due recognition in decision making. The Good Governance is even responsive to the present and future needs of the society (stakeholders) at large. (Agarwal & Medury, 2013) [3].

Good Governance focus is beyond the Laws and Regulations; it aims to create moral behaviour. In fact it is the path to attain ethical practices in the organisation. Whatever might be the mission and vision of the organisation, the ethical role of board of directors and management is the key to obtain Good Corporate Governance. Board of directors have to devise radical change in their perceptions and actions. The Board

should not think for their mutual benefits (Co. and BOD) but for the welfare of all the stakeholders. And the Board must be structured like in a way so that no single director can dominate or manipulate other directors' point of view while making any decision. There must be an equitable distribution of powers. The Board should although work as a team and there should be Group Cohesiveness, but it should never have a Conforming Pressure due to Group Cohesiveness.

Board must be strong but it should always keep in mind the interest of shareholders and also other stakeholders and in order to be true and fair in its decision making, it must have an adequate number of Independent Directors. These directors must be competent enough who can timely control the suspicious activities which in future can lead to any fraudulent accident. The Good Governance ensures more transparency which in turn reduces the risk of any fraudulent activity in future contingency.

### Initiatives by Government to Control Such Frauds

After scams as devastating as Enron and WorldCom were, the investors lost their confidence in the US financial market. It was rather preferred to keep their saving in banks at lower interest income than to invest in the market. Subsequently after the occurrence of such big corporate collapse, the US Govt. passed a new act i.e. Sarbanes-Oxley Act.

Sarbanes Oxley Act or SOX implemented more defined and stricter ways towards compliance of financial statements as well as Corporate Governance. The Key Compliance sections of the act are: SOX- 302, 401, 404, 409, and 802.

Sarbanes-Oxley 302: This section describes compliance regarding Reporting of Financial Statements. Every Periodic Financial Report should be 1) Reviewed and Signed by Officers. 2) The Report must not contain any untrue or falsified information. 3) The Signing Officers are responsible for the internal controls. 4) A list of all internal deficiencies along with the defaulting employees must be included in financial report.

Sarbanes-Oxley 401: This section makes it mandatory to present all the off-balance sheet liabilities, obligations or transactions in financial statements.

Sarbanes-Oxley 404: It deals with the effectiveness, scope and adequacy of internal control structure and procedures.

Sarbanes-Oxley 409: The companies, according to this section are required to disclose any information on material changes in financial statements or operations of the organisations on an urgent basis to the public.

Sarbanes Oxley 802: This section impose penalties of fine or/and imprisonment up to 20 years for concealing, falsifying, destroying, altering or/and mutilating any financial record with the intention to obstruct or influence any legal proceedings or investigation. The accountants who are involved in violating the requirement of maintenance of audits for a period of 5 years are also punishable with a penalty of fines and/or imprisonment up to 10 years. (soxlaw.com)

The Government of USA also bailed out many big scandals to keep the financial market on the track and to retain the belief of investors in the market. Few of such bailouts are:

1. Bank Rescue of 2008; officially called the Emergency
2. Economic Stabilisation Act
3. Bail out to AIG.
4. Fannie Mae and Freddie Mac 2008

In India also the new Companies Act 2013, was a successful attempt to prevent the fraudulent accidents inspired by US

Government's initiatives. Many new provisions added to the new companies act focused on strong Corporate Governance Mechanism to avoid the frauds.

One of them is regarding compulsory requirement of the minimum number of independent directors. For every listed company, it must have at least one third of its directors as independent directors.

Second very important provision is regarding audit committee. Section 177 of new companies act requires the following classes of companies to constitute an Audit Committee:

Every Listed Company or public company with a paid up capital of Rs. 10 Crores or more or Every Listed Company or public company with a turnover of Rs. 100 Crore or more or All public companies with an outstanding loan or borrowing or debenture or deposits of Rs. 50 Crore or more. (The Institute of Company Secretaries of India, 2014) Audit Committees are made more powerful under new act. Also the provisions regarding Insider Trading and protection to Whistle Blower have been added.

There are many such initiatives worldwide by the state to control such frauds. In US, SEC Act 1934 not only prohibits insider trading but it also empowers the SEC to investigate in suspected cases of insider trading and prosecute the guilty. In UK, also acts are working similarly i.e. The Criminal Justice Act, 1993.

### Recommendations

After analysing all the above cases, it is clear that the frauds are not only the result of outside factors but it emerges from within the organisation. It has been observed that the people who should have been the protectors of the company become its demolisher. Creator or promoter becomes the eradicator. CEO, CFO, KMPs, Founders' greediness becomes the root cause of the big scandals. And to avoid all such malfunctioning by the key managerial personnel, firstly, there needs to be a sense of belongingness in the employees towards their organisation. Secondly, there need to be a particular focus on the Internal Control System of the organisation so that every step of each employee is rechecked and verified with the next step of the next employee. Third, with no doubt a strong Good Corporate Governance Structure increases the sense of ethical belongingness to the company which drives down the immoral and unethical behaviour of the people. Fourth, Laws of the state should be more innovative as the Scams have become more dynamic. And lastly there should be a focus on how to develop an ETHICAL BEHAVIOUR IN THE CORPORATE WORLD. The corporate world today is in dire need to understand the benefits of ethical behaviour which not only helps in building reputation and image of the organisation but it also creates an honest working environment and indeed reduce the risk of future frauds.

### Conclusion

The scandals are like a termite in the wooden house, it damages an organisation from inside slowly and steadily and then weaken the whole organisation so much, that the entire wealth and goodwill of the organisation comes into the Red-Zone. We in this paper came to know that why do scams originate, most of the time it was the same reason like greedy CEO, CFO, corrupt founder, unrest within the key employee and these factors become the pressure/motivation and the lack of strong governance structure weak internal control system became the

opportunity to convert those intentions into reality. And as far as frauds' solution is concerned the best quote is- "Prevention is better than Cure". After the frauds take place; it's really difficult to indemnify the position back into the original one as there is not just the financial loss but also the loss of corporate goodwill and most importantly the investors' confidence is lost. Although, stricter laws are being implemented by the different economies specially the USA, even then the level of scams and scandals have not been decreasing, so it is better to start focusing on good governance structure and to develop an ethical behaviour within the minds of employees. A good employee driven by a good ethical and moral behaviour will never commit fraudulent acts. So along with the stricter laws and regulation if we try to vanish the intentions of doing frauds from the employees' minds that will lead to the success of this track.

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