Corporate and Financial Crimes: A Background

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In a country like India, where a man as popular as Baba Ram Dev was literally thrown out of New Delhi, when he was trying to protest peacefully against corruption, the author really had to think before coming out with his view in the form of this book. This book contains financial and corporate laws and crimes and criminals related to them. But he holds himself here to accept what one wish man always said, "Existence of laws is one thing, and their implementation is something another, something very difficult".

The fact of lack of implementation is much evident from the fact that the apex court of India had to exercise the scope of judicial preview to its fullest, letting the government know the supremacy of the rule of law, may it we the quashing of the appointment of the CVC, or monitoring of the 2G spectrum matter, on prevention of mass spoilage of food grains happening in the godowns of Food Corporation of India (especially when millions of souls sleep without food at night in our country). The courts have really taken the task in their hand, and it has been in the best of interests of the country and its citizens.

A burning example of the systematic injustice was seen when a child suffering from cancer was denied treatment by most of the batter government hospital is in New Delhi. The only respite to the child came when his father filed a petition with the court in New Delhi, asking for a basis right to get treated and for medical help. And no prize for guessing that he was provided that right by the orders of the court.

India has diversity, and diversity creates confusion. Confusion not qua making the laws, but for its implementation. A lot of implementation has happened in India in the years 2009, 2010 and 2011, for the good of the country.

Apart from the usual crimes, now have evolved the white collar crimes, which are more difficult to detect since they are the result of well trained brains.

Incorporate the deterrence of illegal acts and fraud requires coordinated efforts by the management, audit committee and auditors. Falsification of books of accounts constitutes fraud and illegal act.

Besides Illegal acts, corporate frauds can fall into two categories –one leading to falsification of accounting records and the other misappropriation of assets or fraudulent expenditures. Fraud analysis find three causal factors constituting a triangle in all frauds. The best way to reduce the occurrence of fraud is strengthening the internal control system. All though the Association of certified fraud Examiners and National Association of Certified valuation Analysts have also elaborated effective controls to deter fraud, yet still most of the companies have no anti-fraud policies. A multi-pronged strategy to take action to prevent corporate frauds when organisations are expanding beyond borders, and system and producer, become complex, the management needs to be more vigilant.

Identification of the fraud vulnerability and actions to detect, control and prevent control deficiencies for effective enterprises risk management by reducing the likelihood of susceptibilities are important in this century.

The financial crimes are nothing new. They have existed since ages. For this century, the story started with early 2000, when the infamous Enron moved away from its core business of electricity and natural gas towards trading in derivatives. It believed that the profits from derivatives could be used to mask the loose of its primary business. Enron started incurring massive debts. Though its derivatives related asset yields grew by good numbers, liabilities also piled up rapidly. The trouble began in 2001. Enron created multiple special purpose Vehicles to hide bad investments in derivatives as well as its poorly performing assets in the energy business.

It is started avoiding millions in tax dues by using its stock options. Its financial condition was sustained by institutionalized, systematic and creatively planed accounting fraud. In the mean time it lost exclusive rights to its pipelines.

For the third quarter of 2001, it reported a huge $618million loss, and on November 4, 2001 it told its investors that they were restarting profits for the

last four and quarter years. Finally, on December 2, 2001 the company filed for bankruptcy. The scandal created such waves in the auditing community that it led to the dissolution of Arthur Andersen, one of the world's top accounting firms.

Followed by Enron was WorldCom scandal. WorldCom was the United States second largest long-distance phone operator between 1998 and 2002. During the 1990s, WorldCom was involved in acquisitions and completed several "mega-deals" which later turned our detrimental. In the year 1999, revenue growth stalled. The company started borrowing money to cover up losses. By March 2002, the Securities and Exchange Commission (SEC) requested for information from WorldCom, suspecting fraud, as AT&T was losing money even as WorldCom wasn't. What was feared came to be true when, in July, the company announced bankruptcy and that month it declared that it had been inflating profits by $3.8 billion over the previous five quarters. The company inflated profits by classifying routine expense as investments and long-term expenses, it also capitalized "line cost"-fees to third party operations to carry traffic. Not much after the WorldCom scandal shook the financial market, the office equipment-marker, Xerox, in the June 2002, admitted to overstating its revenues and profits for the years 1997-2001. This allowed the company to meet profits expectations. When SEC began an investigation, it exposed the fact that over five years the company had improperly classified over $6 billion in revenue, leading to an overstatement of earnings by nearly $2 billion.

The popular internet service provider America Online (AOL) was accused of playing around with its finances in the early 1990s. In these years, changing its amortization policies and capitalizing revenue expenses was commonly followed practice in US. The magnitude of fraud began to increase with competition. And from March 2000 through January 2002, the company indulged in material misstatements of its financial results, including overstatements of operating income and free cash flow, overstatements of net income, understatements of net losses and total debt. The intention was to report that it had met its new subscriber targets, an important metric the

market used to evaluate AOL. The bigger loss had fallen on someone else, since in the meanwhile Times Warner had taken over AOL. This resulted in Time Warner paying $300 million to SEC as civil penalties. According to a report dated March 18, 2008 by KPMG, Corporate India is unprepared to handle fraud.

India is perceived as a fraud-haven with inadequacy of anti-fraud measures and unethical behavior of employees. The dual impact of two concerns rated high by respondents i.e., unethical behavior of employees and inadequacy of anti-fraud measures, lead to an environment where both inclination and opportunity co-exist. This could mean that organizations in India that remain passive in their approach to deal with fraud may be a perfect breeding ground for fraud, suggest the findings of the latest KPMG report on fraud. The findings of the KPNG report suggest that the threat of fraud, suggests the finding of the latest KPMG report on fraud.

- Over 70 percent corporate believe fraud in India will increase over next two years.
- Supplier kickback most prevalent form of fraud to hit an organization.
- Theft of Intellectual Property and IT-related fraud will increase in coming years.
- Organization lack effective internal control mechanisms of manage risks.

The finding of the KPMG report suggests that the threat of fraud comes mostly from within the organization. A majority of the respondents believe that the employees pose the maximum threat to an organization and the senior management as compared to other employees is more likely to commit fraud. The inherent responsibilities and trust associated with senior possession the ability to override internal controls, internal knowledge and access to confidential company information that come with the managerial possession create the risk that fraudulent acts may occur. Next to employees the maximum threat is perceived from supplier and service providers. Hence it is not

surprising to know that collusion between the two would be a major area of concern.

Supplier kickbacks are the most prevalent type of fraud being faced by the organizations today. The KPMG report highlights that typically companies refrain from taking legal action again fraud perpetrators and prefer separating the perpetrators of fraud from the company (employees) or stop dealing with them (external parties). Action taken by the organizations greatly depends upon their outlook and tolerance towards fraud as well as their appetite to deal with the law enforcement and legal channels, should they choose to prosecute perpetrators.

The concept of corporate criminal liability and the limit there of has not been defined by the legislature anywhere. The gap between the legislation and the corporate criminal brains has widened ever since. It has become more common than ever these days, that whenever a big corporate crime has been committed, it is only done under the garb of a corporate mask. I have concised the judicial view taken by the courts on the limits of corporate liability, in another chapter on Corporate Criminal Liability, in my book title d as Corporate Crimes and Financial Frauds.

The number of deaths which take place during a year on account of various crimes is usually accounted for by the police agencies. However, the deaths which are the result of corporate crimes are never accounted for. These include deaths of labor occurred while construction of big commercial and residential complexes by builders , deaths of consumers cause due to faulty products of companies, corporate pollution and not to forget deaths and cancers caused by sale of tobacco and pan masala. Sadly, India has no figures regarding the death toll on account of these corporate deaths.

However, there is some data available with the US department of Justice, which has explained in its 2001-2006 strategic plan, that “precise financial losses resulting from White collar Crime (WCC) for consumers, government, and business are known since no systematic data collection exists”

Corporations also cause more violence and death than street criminals. The US national murder rate reported by the FBI is about 13,000/- for the year 2011. Compare that to the number of people who die from corporate – related causes each year:

a) According to the Bureau of Labour Statistics' annual report on workplace fatalities, 4,547 people died on the job in USA in the year 2010. This preliminary number is slightly lower the 4,551 fatal injuries recorded in 2009, and the lowest on record since the Bureau of labour Statistics began tracking this information in 1992.
b) Another study estimates that 70,000/- Americans die annually from product – related accidents, and millions more suffer disabling injuries at a cost of over $100 billion in property damage, lost wages, insurance, litigation, and medical expenses. Despite improved regulations, the Consumer Products Safety Commission estimate that "there remain 27,100 deaths and 33.1 million injuries each year" related to consumer products under jurisdiction.
c) These numbers do not include the 1000 of annual deaths caused by cancer and other diseases linked to corporate pollution, defective products, tainted food and addictive substances such as tobacco, and other causes. And estimated 553,400 people in US died from cancer in 2001 (See J. NCI: 93:10, state Bite, May 6, 2001).
d) As the need of today, corporate criminal responsibility must be fixed and enforced in an effective manner to plug the hole of corporate criminal leakage from the hands of law. Concepts like corporate governance seen attractive when discussed in board meetings or investor seminars. The actually don't in the real word for the purposes of private limited companies. The situation in privately owned companies is more complex than in the PSUs and MNCSs where there are clearly defined dominant share holders. In the Indian business groups, the concept of dominant shareholders is more amorphous for two reasons. First, the promoters' shareholding is spread across several friends and relatives as well as corporate entities it is sometime difficult to establish the total effective holding of this group. Second, the aggregate holding of all these entities

taken together is typically well below a majority stake. In many cases the promoter may not even be the largest single shareholder. What makes the promoters the dominant shareholder is that a large chunk of the share is held by state – owned financial institutions which have historically played a passive role. So passive have they been that in the few cases where they become involved corporate governance issues, they were widely seen as acting at the behest of their political master and not in pursuance of their financial interests.

In comparison with developed countries that imposed stringent penal and criminal consequences for poor corporate governance, penalty levels in India are considered to be inadequate to enforce good governance. Greater efforts are still required to stop the corporate crimes being committed. And that can only be achieved effective legislation on corporate crimes and fixation of liability of corporate offenders.