CORPORATE FRAUDS: EMERGING ISSUES AND PREVENTIVE STRATEGIES

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Introduction

The past few years have seen several headline grabbing incidents of corporate frauds around the globe. From the financial scandals such as *Sahara*, *Satyam*, *Tyco* and *Enron* it looks like corporate fraud has become an unruly plague which is persistently increasing and having sent ripples worldwide. A corporate fraud occurs when a corporate deliberately changes its information in order to embrace its presence in market. It occurs even when an employee of an organization with his connivance perpetrates fraud by embezzlement, corruption or makes false expense claims resulting in financial gain. According to *the Report of the Nation's 2016 global Fraud Survey*[1], a typical organization loss 5% of revenues in the given year as a result of fraud.

In India, scams are integral part of corporate history. It can have devastating consequences for the organization, stakeholders and general public. Certain provisions relating to corporate frauds find its place in few of the Indian statutes. One of such statutes is Companies Act, 2013 which capsulate the concept of fraud and provisions for stringent punishment. Though we have mechanism in the form of enough legal and regulatory provisions, problem lies with the enforcement and implementation which is need of the hour. Thus , the present Article seeks to analyze and examine in depth i) the concept of corporate fraud as understood globally ii) various legislations incorporating punishment for corporate frauds in India iii) certain steps to minimize the occurrence of such frauds in future.

As long as humans have been in existence, fraud and betrayal would have too. It's an old maxim that fraud vitiates anything it

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1 Report to The Nations On Occupational Fraud And Abuse 2016, *available at* http://www.acfe.com/rttn2016/docs/2016-report-to-the-nations.pdf--Report.

touches. It is a felonious deception resulting in economic gain by the perpetrator. Fraud can take indefinite variety of forms. With changes in technology, frauds have taken the shape of organized crime, utilizing sophisticated methods for its commission. It has increased vividly with the expansion of modern technology and the global super highways of communication, resulting in accretion of economic loss with each passing year. Early references to fraud in English common law[22] define 'fraud' as cheating or deceit. A perpetrator or fraudster was one who by false artifice and false representations induced another to part with his property or rights.

There is no globally accepted definition for the term 'fraud'. The laws or statutes in many countries do not define it or specify the same. We can say that Fraud is any kind of harm or damage committed to take advantage over other person with malicious intention. There are three elements involved which are-an act, damage or possible loss to other person and intention to deceit. According to the *Oxford Dictionary*, fraud is a criminal deception; the use of false representation to gain an unjust advantage over another. Deceit implies imposing a false idea or belief which causes ignorance, bewilderment or helplessness. There are three ways to illegally relieve a victim of money-force, trick or theft-all offences that employ trickery are Frauds in one way or the other. While fraud is just one of the risks on this list, it is faced by all commercial and government entities.

Corporate frauds

The dimensions of financial fraud are many but the most significant among them which needs immediate attention whose consequences may be devastating are corporate frauds. Fraud occurring within an organization is particularly known as corporate fraud. It basically involves deliberate deception to the public, investors, stakeholders or to the financial Institutions resulting in financial gain to the fraudster. It has significant repercussions on the corporates or financial organizations. In corporate frauds, a group of corrupt individuals manipulate the business of a company in order to gain unfair advantage or benefits. It often bestows illegal or improper means. Today, Organizations of all kinds and spheres are victims to fraud in one way or the other. According to *Survey on Financial and Corporate Frauds 2016*[3], it was revealed that the cases of financial frauds

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2 Rider Barry (ed): Research Handbook on International Financial Crime, Edward Elgar Publishing Ltd, US, 2015, pg no 182.

3 Financial and Corporate Frauds Survey, *available at* are on rise in India and as the economy is growing, increasing corporate frauds will prove to be disastrous for India. Some of the challenges prevalent in the current environment are technology, non-performance of fraud risk assessment, lack of segregation of duties and ethical behavior among the employees.

According to ASSOCHAM Secretary General D.S. Rawat[4] corporate wrongdoing inevitably ends up creating a vicious cycle that hurts shareholders value, damages investor's trust, leads to locking up of capital in litigation and ultimately causes wider financial market instability; eventually becoming part of much larger problems. Further, corporate frauds rose by over 45 % in last two years and the lurking risk has been dissuading global companies from investing in India, according to the study by *ASSOCHAM and Grand Thornton 2015 Survey.*

Corporate fraud is any fraud perpetrated by, for or against a business corporation. Corporate frauds can be committed by employees or executives working in an organization against it or can be committed by externals such as vendors, suppliers or customers against the corporation. It encompasses a range of misdemeanors at all levels of an organizational hierarchy.

The Internal Resources Service, Department of the USA of the Treasury,[5] defines a corporate fraud as a violation of the Internal Revenue Code and related statutes committed by large, publicly traded corporations and/or by their senior executives. Corporate frauds, conceptually, is broad and encompasses a variety of criminal and civil violations. In addition, corporate frauds have gradually become very complex in nature

Corporate frauds are also known as corporate crimes or organizational crimes. They are part of white-collar crimes. White collar crimes were defined by an American Sociologist Edwin Sutherland as 'one committed by a person of respectability and high social status in the course of his occupation'.[6] Such crimes are committed by individuals within their organization, for personal benefit of themselves or for their employing organization.

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http://www.grantthornton.in/globalassets/1.-member-firms/india/assets/pdfs/financial-and-corporate-frauds.pdf.

4 Corporate fraud in India rose 45% last two years, *available at* https://economictimes.indiatimes.com/news/company/corporate-trends/corporate-fraud-in-india-rose-45-last-two-/articleshow/45889366.cms?intenttarget=no years-study.

5 Professor Roman Tomasic: 'From white collar to corporate crime and beyond', *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1433437.

6 Amarjeet Singh: 'White Collar Crimes' available on www.scconline.com.

Corporate executives who commit such illegal acts do not think of themselves as criminals, they believe as it is part of their organizational environment. Their inappropriate behavior is often informally approved by corporate sub-cultures. Organizations of all types and sizes are victims to fraud in one way or the other.

Not only that the corporate frauds do have a significant financial impact, but if severe, it can also destroy an organization. Such frauds are considered to be notorious and most troublesome. It can tremble the morale to shareholders and investors of organizations. Corporate fraud is regarded as a process or an act which is the product of organized activities which take place over the period of time.[7] While there are many types of fraud, there are few that can cause the utmost damage.

Categories of corporate frauds

- **Asset misappropriation:** It is a theft or misuse of organization's cash or assets belonging to a company. It can be done by directors, employees or persons who are entrusted with the company's assets. Asset misappropriation schemes include those frauds in which perpetrator employ tricks to steal or misuse organization's assets. Assets stolen can be in the form of cash, credit note or vouchers. *Modus operandi* for such frauds is fictitious sales, false inventory, falsifying asset requisition and transfer.
- **Bribery and corruption:** Bribery and corruption are serious economic crime as it affects company's economic development. Bribery involves offering, giving or receiving anything that influences an official act**.** Corruption is much wider concept which includes bribery, illicit gratification and economic extortion. Employees improperly use their power in business transactions to gain some advantage for themselves or another person. It is reflected in latest cases that CEO and managing directors are found directly involved in bribery to get projects and approval beyond their capabilities with the help of companies board.
- **Financial fraud statements:** It usually involves misrepresentation of financial statements of the company. It can be most damaging to the company. This type of

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7 Ana Paula Paulino da Costa and Thomaz Wood Jr. on ' Corporate Fraud', *available at* http://www.scielo.br/scielo.php?script=sci_arttext&pid=S0034-75902012000400008.

frauds take the form of manipulating accounts, Overstating revenue assets and investments , understating liabilities and non-disclosure of certain vital information. *Enron*, *WorldCom* and *Satyam* are recent, high profile cases involving financial statement fraud.

- **Corporate espionage:** The term 'corporate espionage' has become synonymous with industrial espionage. With the increase in competition in business ventures, corporates started resorting to innovative methods to obtain information about other companies or competitors. Officials steal the trade secrets by removing or copying confidential or valuable information of a competitor for its company's benefit. Corporates gets benefited financially through this kind of frauds.
- **Investment trends:** Investment scams leads to financial loss to the investors and even loss of their lives. Loopholes in the investment system give way to the perpetrator to procure proceeds from the scam. Bogus companies are formed just to manipulate and hide the bogus transactions. Harshad Mehta, Ketan Parekh and Sahara Group scams are few names which the Stock market in India will always remember with grief.
- **Insider trading:** Insider trading is defined as a trading in company's stocks or securities by persons who are predicted to gain access to the subtle information in respect to such securities. Taking advantage of such information is prohibited under the respective securities laws of different countries. The *Rajat Gupta* Case is one of the biggest scandals in history of US for the offence of insider trading.

Concept of corporate frauds in India

India has become a corporate hub in past decades. Corporate frauds have become a threat to the society and financial Industry specifically as financial loss by these kinds of frauds are much greater than loss from robberies, theft, swindling etc. The society cannot survive with them but cannot even live even without them In India, organizations irrespective of their gamut and orbit are subject to fraud. It causes enormous consequences to the organization, stakeholders and general public. Our country being a silent spectator of several corporate frauds, few of them being the *Harshad Mehta scam of 1992*, *Satyam scandal in 2009*, *Saradha Chit Fund scam* and *Sahara Fraud* Case. These infamous scandals have adversely affected the development of the economic sector of our country.

Regulations pertaining to corporate frauds

There are certain sweeping regulations which have helped in preventing and detecting frauds which earlier went undetected. Certain provisions relating to corporate frauds find its room in few of the Indian Statutes. One of such statutes for preventing and curbing corporate frauds is the Companies Act 2013[8]. It consists of both civil as well as criminal liability for the perpetrator. The major provision introducing the concept of fraud finds place in Sec. 447 which is reproduced below:

> "Any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss."

There are certain provisions in the Companies Act which attract civil as well criminal liability for corporate fraud. They can be divided into pre-fraud stage and post-fraud stage.

- **Pre-fraud stage**: Fraud can be prevented by curing it in initial stage itself. Some categories of fraud to be dealt at this stage are Incorporation of company related fraud, share capital frauds, or transfer/transmission of shares to defraud, miss-statement in prospectus, fraudulent inducement for investment.
- **Post-fraud stage:** If not prevented earlier, the fraudster needs to be prosecuted or penalized to deter other perpetrators. Such category of frauds include carrying business for unlawful purpose, fraudulent conduct of business, financial statement fraud, failure to repay deposits, insider trading, fraudulent removal of name of company, removal of auditors or penalties for fraud.

Regulators serve two primary functions in a nation: they implement laws and they enforce it. Regulators for corporate frauds as per the Companies Act are Serious Fraud Investigation Office (SFIO) and National Company Law Tribunal (NCLT).

8 Ramaiya A: Guide to Companies Act, Volume 3, LexisNexis publication, Haryana, 18th edition, 2015, pg no 5709.

- **Serious Fraud Investigation Office**: It is a multi-functional investigative agency consisting of experts for timely and effective detection of frauds. It investigate into affairs or cases of company involving financial frauds as may be assigned to it from time to it from time to time by the Central Government. It also has the power to arrest in cases where a person is believed to be guilty of offence under the Companies Act.[9]
- **National Company Law Tribunal:** It is a quasi-judicial authority created to handle corporate disputes arising under the Act. It is vested with powers to provide relief for class action suits, oppression and mismanagement, refusal to transfer shares, assessing against delinquent directors, demerger or winding up and punishment for fraudulent conduct of business. Its orders can remedy a situation, correct a wrong or levy penalties/costs. The Tribunal is not bound by the strict rules relating to procedure. It can decide cases by following the principles of natural justice.[10]

Corporate frauds also involve securities fraud as securities are dealt by the corporates irrespective of being public or private. Therefore it is essential to have a glance pertaining to securities related frauds. Securities fraud is a kind to fraud which covers a wide range of illegal activities, which involves deception or manipulations in sale or purchase of securities in the securities market. It is perpetrated either by the company, its employee or third party. Instances of securities fraud are manipulating stock prices, misrepresenting or omitting important information, insider trading or otherwise violating securities regulations. Security and Exchange Board of India (SEBI) has been a regulator for securities market and is empowered to remedy the mischief sought to be prevented. Certain sections under SEBI Act 1992[11] empower SEBI to take measures against fraudulent and unfair trade practice and insider trading. SEBI is one of the most powerful regulatory authorities for the securities frauds. Certain provisions which are significant for dealing with securities frauds are provided below:

- **Sec.12A:** prohibits manipulative and deceptive devices, insider trading and substantial acquisition of securities against the regulations of SEBI.

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9 *Available at* http://www.sfio.nic.in/inves_proc.aspx.

10 *Available at* http://nclt.gov.in/.

11 Parekh Sandeep: Fraud, Manipulation and Insider Trading, Wolters Kluwer, Punjab, Second edition, 2016, pg no 267.

- **Sec.15**: SEBI provide for penalties in cases of insider trading, nondisclosure of shares, failure to refund moneys to investors and also for fraudulent and unfair trade practices.

SEBI has within itself facets of the executive, legislature and judiciary. SEBI performs various functions right from an investigator to a supervisor in controlling the unlawful activities committed to the detriment of the investor in the Securities market. It has the authority to make rules, notifications and provisions to regulate the Stock market. SEBI has the powers of civil court and has the authority to levy pecuniary penalties ranging from 1 lakh to crores of rupees and pass multiple orders such as suspend or cancel certificate of registration or from prohibiting the company or entity to enter or access the securities markets, relinquish the wrongful gains and so on.[12]

Trust reinforces the existence and development of financial markets of any country. Various forms of financial frauds may compromise can put financial institutions at stake. Financial fraud affects common people, investors who invest their hard earned money, commercial organization and gives a negative impact on the entire economy and to our social system through the loss of money and wealth. It can weaken the financial system of any country.

Infamous corporate scams in India

In the last few years, scams involving corporate fraud have made headlines in the papers globally. There were high profile cases from *Enron* to *Satyam* which have been widely analyzed and discussed by the professionals and experts. A search for the term 'corporate fraud' in *Google*, generated more than a 10 million entries, which proves towards the popularity of this issue. On the global piece, India also went through an upheaval, the reason being corporate frauds. Some of the infamous cases are discussed below:

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12 Shantanu Mitra: 'Securities fraud in India: SEBI as an investigator and enforcer', *available at* http://www.legaleraonline.com/articles/securities-fraud-in-indiasebi-as-an-investigator-and-enforcer.

- ***Harshad Mehta scam***: In April 1992, the Indian Stock market crashed and Harshad Mehta who was considered as architect for Bull Run was blamed for the crash. It grabbed headlines for the notorious BSE security scam when veteran columnist Sucheta Dalal wrote an article in India's national daily *The Times of India*[13]. He manipulated Indian banking system to siphon off the funds from the banking system and used liquidity to build large positions in selected group of stocks. He diverted funds to the tune of Rs. 4000 crore from the banks to stock brokers. He was later charged with multiple criminal offences.

- ***Satyam scam*:** Ramalinga Raju was held guilty by trial court which sentenced him to seven years rigorous imprisonment with fine of Rs. 5 crores. The nation all over was shocked and scandalized with the scam. It is also known as *India's Enron*. It was probably the biggest corporate scam from one of the largest IT Companies in India i.e., Satyam Computer Services Limited (M/s SCSL). The scam triggered the loss to investors to the tune of Rs. 8000 crore. Ramalinga Raju confessed in his letter that he cooked books of accounts of the company and admitted that the accounting entries were wrongly inflated. He overstated the income nearly every quarter over the course of several years in order to meet investor's expectations. Weak independent directors and negligence of auditors also contributed to *the scam*.[14]

- ***Saradha Group Chit Fund scam*:** The Ponzi Scheme was started by Saradha Group in collected money from investors by issuing redeemable bonds and secured debentures and promising incredulously high profits from reasonable investments. Local agents were hired throughout the State of West Bengal and given huge cash payouts from investor deposits to expand quickly, eventually forming a conglomerate of more than 200 companies. To keep ahead of regulatory bodies, the group

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13 Gupta Sanjeev Dr: Corporate Frauds and Their Regulation in India, Bharat Law House Pvt. Ltd., New Delhi, First edition, 2016, pg no 64.

14 The Satyam Scam Case 2009, *available at* http://cbi.nic.in/fromarchives/satyam/satyam.php.

used a nexus of companies to launder money.[15] In April 2013, the group collapsed causing estimate loss of approximately 200 to 300 billion to millions of depositors and agents. SEBI barred Saradha Group and its Managing Director Sudipto Sen from securities market till the company winds up such schemes and refund the amount to investors.

Infamous corporate scams abroad

Corporate frauds remain a constant risk. No matter how meticulously the companies try to crack down on fraud, it is increasing with every passage of time. Scams have been rampant in other countries too apart from our nation. Some infamous scams are briefed here:

- ***Enron scandal***: With *Enron scandal*, The United States of America witnessed the biggest corporate collapse in its corporate history in the early days of December, 2001, which sent shock waves across the whole business world. Enron, until the collapse, was held in high esteem by well-known corporate observers, analysts and corporate rating agencies in the United States of America. Many executives of Enron were indicted and charged for several fraudulent activities, ranging from insider trading, corrupt business practices, money laundering, falsification of accounting records, financial misappropriation etc. They were processed in courts and several of them were then sentenced to prison. As a consequence of the *Enron Scandal*, the US enacted new regulations and legislations to increase the relevant business rules to ensure accuracy of financial reporting for public companies, one of them being the Sarbanes-Oxley Act, 2002.[16]

15 Dr. Mini Amit Arrawatia and Mr. Vikram Pande: 'A study of ponzi scheme with reference to Sharada scam', International Journal of Science, Technology and Management', Vol. 5 Issue 2, 2016, *available at* http://www.ijstm.com/images/short_pdf/1455286111_558Y.pdf.

16 Francis Denteh: 'Enron: Fraud Detection Timeliness', *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1920747.

- ***WorldCom scandal***: WorldCom was once considered to be second largest telecommunication company in United States. But by 2002 its CFO and CEO were convicted for series of accounts adjustments, and inflating company's assets. During the yearlong investigations by Security and Exchange Commission, nine billion dollars around in discrepancies were found. It is considered to be the worst crime in the US history**.**

- ***Rajat Gupta* Case**: The India born former Goldman Sach's Director Rajat Gupta was convicted by a US District Court in New York in connection with the biggest insider trading case in the US history. He has been sentenced to two years in prison for leaking Goldman Sachs boardroom secrets. The Security and Exchange Commission also obtained $13.9 million as civil penalty apart from permanently barring him from acting as an officer or director of a public company.[17]

Conclusion

Corporate frauds are rising globally and in India as well. Fraudsters see financial institutions as a series of process that they need to overcome, but once speared, the rewards can be magnanimous. Fraudulent acts have become a gigantic devil that has petrified the system and the society as a whole. In escalating rate, we are today watching that persons, who are endowed with the significant task of managing businesses, manage for their own interest. Corporate fraud has become an debatable moot point for the academicians who study it, investigators and experts who explore it, and intellects debate it. Thus the society is focusing more towards handling the aftermaths of frauds than preventing it.

With the mirror view image of the growing fraud, there is an urgent need to take strict and focused steps is felt. Though a crime free society is idealistic, we should put consistent efforts to keep them at the lowest. Law makers and regulators have to go an extra mile ahead of fraudsters to keep them at bay. Though we have variety of legislations relating to corporate frauds as

17 *Available at* http://www.thehindu.com/news/international/world/Rajat-Gupta-fined-13.9-million-for-insider-trading/article12010778.ece.

mentioned earlier which can be looked into as a source to investigate fraud related cases, we can rather take strategic steps such as:

- Providing more powers to the investigators and regulators especially SEBI;
- True adoption of international financial reporting standards;
- Enforcement agencies should focus more on identification and prevention of such frauds which is a chief concern;
- Punishment of the culprit and delinquent persons of the corporates can minimize fraud to a greater extent;
- More emphasis should be laid on enforcement of new regulatory paradigm;
- Close liaison should be maintained between regulators such as SEBI, CBI, ED and SFIO; and
- Whistle blower policy is one of the best ways in safeguarding against corporate frauds.