

Corporate Fraud: Risks and Challenges Ahead



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Companies around the world lose an estimated 5% of revenues each year on account of fraud... this translates to a potential projected global fraud loss of nearly \$3.7 trillion.

2014 Global Fraud Study, Association of Certified Fraud Examiners

Fraud for centuries has been an integral part of the human society and every society defined its own methods to counter and deter fraud and deceit. Fraud continue to remain widespread enigma regardless of industry or region in which business operates.¹ Fraud can defined as a conduct involving use of dishonest or deceitful means to obtain unjust advantage or gain over another.

Corporate fraud is one that occurs within an organisation or by its owners or managers and involves deliberate dishonesty to deceive the public, investors or lending companies, usually resulting in financial gain to the individuals or organisation.²

Corporate fraud and misdemeanours are real and pervasive threat to public trust and their confidence in the capital markets and such infractions are ever evolving and unpredictable and its impact ever increasing.

A significant emphasis has been placed on prevention and detection of corporate fraud in India affects numerous investors, public and stakeholders in the recently promulgated law and regulations..

Prior Research and Learning : Corporate Fraud - Risk and its Consequences

The Global Fraud Report, 2013/14³ reports that at least 70% of the companies reported that there suffered from at least one type of fraud in the past year, up from 61% in the previous year. The economic cost for fraud has also increased to 1.4 % revenue from average of 0.9 % with one in 10 businesses reporting a cost of more than 4% of revenue.

In a study, Dyck, Alexander, Morse, Adair and Zingales⁴, find that the probability of a company engaging in a fraud in the USA in any given year is 14.5% and there is a median loss of 20.4 percent in valuations of companies hit by the fraud. They report “on average corporate fraud costs investors 22 per cent of enterprise value of fraud committing firms and 3 percent of enterprise value across all firms.”

The Global Fraud Report 2013/14 points companies exposed to fraud India has increased from 67 % to 71 % and average percentage of loss of revenue has increased to 1.4% in current year in comparison to 1.2%.

The Thought Arbitrage Research Institute(TARI) and UN Global Compact Network report highlights that all the industry sectors in India are equally prone to fraud with manufacturing sector accounting for one out of three cases.⁵ Study points that most of the companies struck by fraud have medium scale of operations with an average revenue size of less than Rs 200 crores. It suggests that in 80% of the cases of fraud have size was less than Rs 200 crores. The average revenue size of companies, exposed to fraud, however, has increased 7.25 times after 2009, exposing larger number of stakeholders to risks of corporate failure.

The consequences of the frauds to the corporates are not just limited to the financial losses. The companies in addition have losses which include reputation losses, cultural losses, loss of customer relationship, low productively and team morale. ⁶

The consequences of fraud are not just limited to corporations, but wide range of stakeholders and entire society bears it. Measuring the social cost of fraud in organizations Karpoff, Lee and Martin (2008) estimate that the social costs of fraud is around 21.8% of enterprise value. Majority of the companies involved in fraud in India either liquidated or discontinued their business or continuing their business at reduced levels with market valuations drastically reduced, therefore significantly impacting the numerous stakeholders and public trust.

The findings of various surveys and reports may vary over the extent and consequences of the fraud, but it is certain that fraud remains a costly and ever increasing problem due to globalization and competitiveness of the markets.

Law for Corporate Fraud in India: *What has changed?*

The company law in India, for the first time defines what is meant by fraud and entails stringent penalties for it. The Section 447 of the Companies Act 2013 defines "**fraud**" in relation to a relation to a company or body corporate as: *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.*

Any person guilty of fraud under section 447 of the Companies Act 2103, is punishable with:

- **Imprisonment** for a term from six months to ten years ;
- **Fine** not be less than the amount involved in the fraud, and may extend to three times the amount involved in the fraud
- Fraud involves **public interest**, imprisonment term cannot be less than three years

There are several sections of the Act that coming under which a person or officer of the company can be held liable for fraud. Some important act of fraud under which a person can be held liable under Section 447 include: inducing persons to invest money (section 36); conducting business of the company with fraudulent or unlawful intent (section 206(4) and 339(3)); fraud, misfeasance or other misconduct or withholding of information (section 213); making false statement in any of the return, report, certificate, statement or any other document (section 448). The offences of the fraud under Act are cognizable and person accused under these sections cannot be released on bail or own bond.

The Companies Act 2013 incorporates several vital provisions to effectively deal with menace of fraud. The Indian company law for the first time necessitates certain companies to establish a vigil mechanism for use only by directors and employees to raise genuine concerns and grievances. It also provides for adequate safeguards against victimisation of whistle-blower.

The new law requires directors to act in good faith to promote the objects of the company and not to achieve or intend to achieve any undue gain/advantage either to themselves or to their relatives, partners, or associates. Any director who is found guilty of making any undue gain is liable to pay an amount equal to that to the company.

Independent directors have entrusted responsibilities with additional responsibilities⁷ to protect interest of stakeholders. They have responsibility of reporting any concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy and act within his authority to protect the legitimate interests of the company, shareholders and its employees.

Auditors of the company (including, Cost Accountants for Cost Audit and Company Secretary in Practice for Secretarial Audit) have made responsible for reporting fraud (Section 143) during the course of performance of its duties to immediately report to the Central Government for any offence involving fraud that is being or has been committed against the company by its officers or employees.

The company Law for the first time allows shareholders and depositors of the company to file class action suits (Section 245) against company, its directors, and auditors for any fraudulent, unlawful or wrongful act or omission or conduct. They have empowered to claim for the compensation or damages on account of fraud committed on them by the company, the directors and auditors of the company.

The company law and securities law, now both give greater empowerment to the enforcement agencies to effectively deal with frauds. The SEBI, now in its legislative capacity can conduct investigations, substantially pass orders, seek information from any person or entity, and put strict sanctions. SEBI has also been given powers to pass disgorgement orders for an amount equivalent to wrongful gains or to losses averted by contravention of regulations. The Serious Fraud Investigation Office (SFIO) has been provided statutory backing under new Company Law (Section 211) for the purpose of investigating the affairs/fraud relating to a company. The SFIO is empowered as a sole authority to investigate such cases, papers, documents for such malafide practices that involve fraud.

Challenges Ahead: Why we should be More Attentive?

In the new regulatory regime, even though substantial effort have been made to cope with nuances of frauds in corporate India, significant challenges still prevail to effectively deal with fraud in businesses. Corporates at first need to understand the various regulatory provisions and evaluate the framework that applies for fraud prevention and control.

The post-hoc mechanisms for fraud control in India are quite weak and take out real bite of the whole system. In the new regulatory regime, while stringent punishment have been imposed on perpetrators of the fraud along with greater empowerment of the regulators, time delays and costs involved in prosecution and adjudication of a fraud cases could be real challenging.

The market regulator SEBI, till date out of 1250 prosecution proceeding has able to dispose only 262 cases. From the year 2010-11, out of 120 prosecution cases filed only one case has been disposed of. Similarly from 7368 adjunction proceeding, only 5035 cases are completed. A total 624 adjunction proceeding are pending for over more

than 3 years.

For shareholders, investors and corporations to claim for the damages of the fraud through adjudication of courts is time consuming and uncertain. 2013 *Doing Business* report of the World Bank ranks India at the 186th position worldwide in terms of enforceability of contracts. The report listed various procedural legal steps, which showed that it takes around 1,420 days from the date of filing a claim to the enforcement of a judgment.

What makes situation more precarious that the probability of a cognizable crime committed by a person being registered is 0.082. The probability of conviction of that person for such crime is only 0.006.⁸ Considering such a paltry rate of conviction, a person has rather low risks and high gains from committing corruption and fraud. This provides people greater incentives and motivation to involve such type of fraudulent act.

For an effective regulatory regime to deal with fraud cases, our enforcement agencies need to have better coordination among themselves, more resourceful and leverage technology in prosecution and investigation. Our judicial system need to incorporate steps to bring in greater efficiency in adjudication of cases to reduce staggering time delays. In view of prevailing weak post- hoc mechanisms and uncertainties involved in it, it is wiser to barn the door before the horse bolts. However, vital risks and challenges prevail at that side also.

One of the main challenges in fighting fraud in the businesses could be the fraud committed by the owners or the top management of the company. Most of the companies in India are controlled and managed by their promoters. According to a report⁹, promoters have an overall stake in 63% BSE 500 companies. This induces vital entrenchment effect on promoters to get involved in fraudulent acts to deprive of minority shareholders their rights.

The 2014 report by Association of Certified Fraud Examiners has pointed that higher the perpetrator's level of authority, greater are fraud losses. The cases of fraud by Owners/executives, account for only 19%, but the median loss in these fraud cases is \$500,000. Whereas employees were involved in 42% of frauds cases but the median losses in these frauds was only \$75,000. This implicates a significant concern for companies and investors as there could be fraud cases which in spite of the stringent provisions of the new company. Fraud committed by those in position of responsibility, might not be reported within the organization or to the regulators and enforcement agencies. A detailed ethics and compliance programme need to be developed integrating with anti-fraud mechanism for limiting the opportunity and making it difficult for those in position of responsibility to commit fraud.

The certain companies though need to have a vigil mechanism at place, it would be critical and challenging for companies to ascertain the real fraud case as there may be large numbers of cases and some might be frivolous in nature. Investigating each and every case of fraud is could be costly affair for them. Therefore, corporations need to understand the level of fraud risk they exposed to and will it be wise to undertake investigation in a given. An external expert organization can be good help to companies in this regard, while maintaining the sanctity of vigil system.

Another important challenge to deal with fraud is to understand its' various guises. If a company fails to gauge a fraud and it last for a significant longer period of time, the financial losses and impact of such fraud are significant.¹⁰ Therefore, companies need to adopt anti-fraud measure in pro-active manner to capture fraud at early stages and reduces the fraud losses. They should be attentive to observe the red-flags or warnings signs of fraud. The global fraud study 2014 points that in 92% of fraud cases at least one common behavioural red flag was identified before the fraud was detected. Presence of earnings management¹¹ can be construed to be a potential indicator of presence of financial statement fraud in a company. It is important that organizations, auditors and regulators must remain attentive to recognize these early warning signals, which in combination with other factors can indicate fraud.

In contemporary scenario, technological advancements along with persistent evolution of the global business environment along other enduring obstacles in fraud control provide both additional tool and new challenges for execution and concealment of fraud. The companies, therefore, must be attentive to these challenges and adopt various pro-active anti-fraud measures rather than be reactive. Otherwise, corporate and entire society has to bear the risk of fraud and its consequences, which are becoming more devastating.

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1 2013/2014 Global Fraud Report, Kroll

2 Serious Fraud Office, UK

3 Global Fraud Report by Kroll, 2013/14

4 How Pervasive is a Corporate Fraud? , February 22, 2013

5 Understanding the Demand and Supply Equations of Corruption and Fraud (2013). TARI & UN Compact Global Network India

6 Corporate Resiliency: Managing the growing risk of fraud and corruption, A holistic approach, Report by FICCI & Deloitte, 2013

7 III, Duties of Independent Directors, Schedule IV of the Companies Act 2013

8 Bibek Debroy (2013), Corruption in Public Services, in Fighting Corruption - The Way Forward, ed. Samuel Paul. Academic Publishing, New Delhi

9 Taking Stock: Playing in the Indian Capital Market (2012).Report by Grant Thornton and TARI

10 2014 Global Fraud Study, Association Certified Fraud Examiners

11 Understanding the Demand and Supply Equations of Corruption and Fraud (2013). TARI & UN Compact Global Network India