

Fraud and corruption: protagonists in creating a financial crisis¹

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Introduction

Fraud, corruption, and corporate crime alone or in combination can contribute to the collapse of corporations, be instrumental in a national or global financial crisis or bring a country to a financial cliff. These crimes raise ethical issues and indicate dishonest behavior. Thus, one can also speak of a moral crisis over and above a financial crisis. The financial crisis faced the last few years by countries in the Eurozone and especially in Greece, Cyprus, Spain and Italy has focused on corruption. Corruption is endemic in some countries and stifles development of their economy and modernization of the public service; it is a malignant cancer that sinks a country ever deeper into national debt.

Financial Crisis: Causes and Correlates

Focusing on the financial crises that have occurred since 1980, Dempster (2013) of the Centre for Financial Research at Cambridge University reported the underlying causes to be inflation, currency crashes, currency debasement, and finally asset price bubbles. According to *The Economist*, the 2007-2008 crisis had multiple causes, including years of irresponsible "sub prime" mortgage lending in America and financiers who lost control of the risks involved in using pooled mortgages to back securities known as collateralized debt obligations (CDOs) during a time of prosperity. At the same time, ever-optimistic consumers believed their prosperity would continue because property prices would continue to grow indefinitely, and thus their "sub prime" borrowing would not sink them. These are well summarized by Tomasic (2011) who asserted that "the global financial crisis has revealed massive financial frauds and misconduct that have long been part of our markets but have been submerged by the euphoria that has dominated these markets" (p. 7).

Kaufmann, (2009) claimed that the 2007–2008 financial crisis in the United States was caused by (a) influential members of a community or regulators lobbying for legislation that benefited them, such as lax capital reserve requirements or a relaxed regulatory stance allowing larger amounts of debt; (b) lax regulatory oversight and excessive risks

bringing down multinational corporations; (c) giant mortgage lenders taking advantage of lax oversight and regulators; and (d) authorities and regulators knowing of fraud, corruption, and capture, but ignoring the signs and failing to investigate potential wrongdoing.

For their part, Simpson and Taylor (2013) have argued that corporate financial scandals (e.g., Lehman Brothers) occur because the prevailing corporate culture focuses only on profits. Transparency and accountability, trust, and business ethics are lacking. While there are differing accounts of the etiology of the 2008 global financial and economic crisis Richard Posner (2009) has written about the failure of capitalism due to the crisis whereas for Kemper and Martin (2010, 229) the same crisis has re-written “the relationship between business and society”.

Economic Crime and Fraud

Definitions of fraud vary across jurisdictions and attempts to precisely define it are indeed problematic (Croall 2010), but the fact is the essential element of fraud is deception. Fraud, like corruption, is an example of an *economic crime*, which is a category of white-collar crime. The term *economic crime* covers illegal acts perpetrated by a person or a group of persons to obtain a financial or professional advantage while white-collar crime is committed by a person of high respectability in the society and one that the victim entrusts to carry out a task (e.g. lawyer, accountant, company management, stock broker). In such offenses the offender’s main motive is economic gain. It can be said that the terms white-collar crime, economic crime and fraud overlap.

Large-scale fraud committed by individuals against financial institutions and by the institutions themselves can be catastrophic because such fraud can cause organizations to fail, putting the national economy as well as shareholders’ and other stakeholders’ interests in jeopardy. Although a corrupt public sector and politicians in many countries worldwide deprive large numbers of people of a better standard of living, some types of fraud are perceived as morally ambiguous. This perception explains survey findings that taxation fraud is less of a

concern to the public than credit card fraud that affects them directly (Smith *et al.* 2011, 62).

1. *Mega fraud cases leading to financial collapses*²

A close look at numerous financial crises since the collapse of the Medici Bank in Italy in 1494, shows the crucial role that fraud played in many of them. The 1720 financial crisis (the “South Seas Bubble”) was brought about by insider dealing of government debt by the South Seas Company, which was established to trade with South America. The 1792 crisis in the United States was caused in large part by the Englishman William Duer, and his accomplices who operated a Ponzi scheme whereby they would borrow from rich friends and from the public by issuing personal IOUs to buy federal bonds. These bonds were then sold to investors to pay for United States shares, and Duer would embezzle companies he ran to pay off his own debts. When general economic circumstances forced the bank to impose significant restrictions on the supply of credit because its supply of hard currency had run very low, Duer and his accomplices could no longer borrow and their scam was revealed, accelerating the financial crisis.

A major cause of the 1825 crisis in England was Gregor McGregor, who cashed in on the enthusiasm of wealthy Britons for investing in the new countries of Latin America. McGregor sold “Poyais” bonds on behalf of a new country that in fact did not exist!³ In 1929-1933, during the unprecedented slump in the United States, Clarence Hatry, another Briton, enjoyed a life of luxury as a fraudster across the Atlantic. He established several connected firms in the United States, secured loans against forged share certificates, and was thus able to take over the

² The present section draws on *The Economist* for detailed discussion of five such crises <http://www.economist.com/news/essays/21600451-finance-not-merely-prone-crises-it-shaped-them-five-historical-crises-show-how-aspects-today-s-fina> [accessed September 11, 2014].

³ Guest Author. ‘The fraud of the Prince of Poyais’, July 11, 2013, <http://www.ritholtz.com/blog/2013/07/the-fraud-of-the-prince-of-poyais> [accessed September 11, 2014].

United Steel Company. When discovered, his huge frauds contributed to the London and New York stock markets to crash, accelerating the worst financial crisis in the history of the United States that was already underway. In the early 1970s corporate governance came into vogue through an effort to reduce or even eliminate fraud committed by corporations (Cheffins 2013, 46). Nevertheless, financial scandals continued to occur.

Krambia-Kapardis (2016) mentions the Barrings Bank case where the bank founded in 1762 was brought down in 1995 due to unauthorized speculative trading by a trusted employee. Ten years later, the city of London was shaken when UBS had fallen victim to the “largest trading loss in the British banking history” (*R. v. Kweku Adoboli*, 1) of the magnitude of US\$2.25 billion.

More recently, in the United States, Bernard Lawrence “Bernie” Madoff a highly regarded stockbroker, investment advisor, and financier in New York with impressive credentials and a former non executive chairman of the NASDAQ stock market was sentenced in 2009 to 150 years in prison, the maximum allowed, for investor losses to the magnitude of US\$18 billion.⁴

2. Cost of fraud

The cost of white-collar crime in general and economic crime in particular is multidimensional and substantial worldwide. In the United States alone, the annual financial cost has been estimated to be approximately \$500 billion to \$1 trillion (Friedrichs 2007). Economic crime is a highly prevalent crime and its consequences can be catastrophic. The PricewaterhouseCoopers (2016) Global Economic Crime Survey, found that more than one in three organisations experienced economic crime. The same survey found that employee moral (44%) and reputational harm (32%) were the top forms of damage.

The ACFE (2016) *Report to the Nations on Occupational Fraud and*

⁴ Yang, S. (2014) ‘5 years ago Bernie Madoff was sentenced to 150 years in prison – here’s how his scheme worked’, <http://www.businessinsider.com/how-bernie-madoffs-ponzi-scheme-worked-2014-7>[accessed 21 August 2016]

Abuse found that the typical organization loses 5 percent of its revenue to fraud each year. The total loss caused by the cases in the ACFE study exceeded \$6.3 billion, with an average loss per case of \$2.7 million. In the United Kingdom, the National Fraud Authority (Home Office, 2014) estimated in 2012 that fraudsters cost the nation £73 billion a year. In comparison, this estimate was only £11 billion for 1998 (Krambia-Kapardis 2002). This is in agreement with Smith *et al.* (2011) who stated that fraud “is almost certainly a growing problem” (p. 8).

Fraud victimization studies have been carried out by accounting firms (PricewaterhouseCoopers 2016; Ernst and Young 2015) and researchers (Krambia-Kapardis 2002; Krambia-Kapardis and Papastergiou 2016) in an effort to estimate the cost of fraud to the victims. Despite the limitations of fraud victimization surveys (see Krambia-Kapardis 2002), the method is widely accepted for obtaining information on the typologies of fraud (Brooks, Button, and Frimpong 2009). Interestingly, most organizations do not undertake regular fraud risk measurement exercises; in fact the PricewaterhouseCoopers (2016) global economic survey has found that 1 in 5 respondents from 115 countries have never carried out a fraud risk assessment.

While fraud is a challenging problem, as Gee and Button (2013, 1) reminded us, its impact is broad and it adversely affects the financial cost of public service, the stability and profitability of companies, job security and disposable income, the resources of charities, and the quality of life. When considering the economic costs of fraud, we ought to also account for the cost of investigation, prosecution, sentencing, and imprisonment. Unfortunately, no published research has calculated the total cost of fraud to society.

Aside from the financial burden, fraud victims experience social and psychological costs due to fraud. For instance, those “who have entrusted the financial institution and have deposited their life-long savings in it” (Krambia-Kapardis 2002, 185) may lose all their savings due to a financial crime and the subsequent collapse of their bank. In addition, as a consequence of a major fraud, an employer may be forced to retrench employees or reduce their salaries. Offenders’ family

members may also feel a psychological burden and humiliation and may leave a marriage or the household or even commit suicide (Graybow and Trotta, 2010). Thus, the consequences of fraud are not only financial but also social and psychological, consequences which are often ignored. Let us next consider a phenomenon that is related to fraud, namely corruption.

Corruption

While there is no universally accepted definition, a widely accepted and well-used definition of *corruption* is the one used by the World Bank, which refers to the abuse of public power for private profit. However, as Tanzi (1998) pointed out, this definition excludes corruption in the private sector. The abuse of public power may not necessarily be for one's personal benefit but for friends or even a political party and not all acts of corruption involve the payment of bribes (Tanzi, 1998: 564). Of course, although a bribe implies reciprocity, the distinction between a bribe and a gift is not always easy to make.

There is consensus that corruption is responsible for inefficiency and wastage in the public sector. In this context Bandiera, Pratt, and Valletti (2008) proposed an interesting distinction between *active waste* (i.e., there is usefulness to an official as in the case of bribery) and *passive waste* (e.g., excessive bureaucratic procedures resulting in inefficiency). They analyzed purchases of standardized goods by Italian public bodies in Italy and found that passive waste accounted for 83 percent of total estimated waste (p. 1).

In an effort to delineate the concept of corruption, the following typologies of corruption may well aid in the process: (a) *institutionalized corruption*, which relates to the exploitation of position held to influence activity and people (see Bassiouni and Vetere 1998); (b) *noble cause*, in which epitomes of public servants may break the law to get a conviction or to provide employment to a party affiliate who needs work (Punch 2009); (c) *state-capture*, which refers to the ability of an individual or organization to influence the content of the law (Brooks *et al.* 2013); (d) *bureaucratic corruption*, which transfers power through cor-

rupt activity (Deflem 1995); (e) *political corruption*, which involves high-ranking elected and unelected authorities using their power to make a law or receive bribes in return for a favor at the expense of the public at large (Heidenheimer 1994); (f) where political opportunities are scarce, people use wealth to buy power or use power to get wealth (Huntington 1968); and (g) state *clientelism* (nepotism, favoritism [Médard 1998]).

1. *Cost of corruption*

While identifying different categories of corruption, it has been difficult for researchers to obtain an accurate measure of the extent and seriousness of corruption in a given country. The European Commission (2014) has estimated that 120 billion euros is lost in the EU economy annually due to corruption. Another estimate by the European Parliament (2016) utilizing a mix of methodologies to quantify the overall costs of corruption in the EU in economic, social and political terms suggest that corruption costs the EU between €179bn and €990bn in GDP terms on an annual basis.

Corruption is not easy to measure because it often occurs in secret and involves deception. According to Blackburn and Forgues-Puccio (2007, 1535), the only objective measure of corruption is the number of public officials who have actually been convicted for the offense. This measure has been used by researchers but, as criminologists and others point out, conviction rates do not necessarily reflect the volume of corruption in a community due to the dark figure of corruption and the difficulty in convicting such offenders. Furthermore, as Brook *set al.* (2013, 28) reminded their readers, such measurement is influenced by the resources available, the extent to which laws are enforced, the level of reportability of corruption and, finally, how well law enforcement agencies succeed in convicting perpetrators. By contrast, in a country with a low tolerance for corruption, there may be high corruption reporting and/or conviction rates. Three well-known indicators of corruption in country are the Corruption Perception Index (CPI) published annually by Transparency International, and two indicators

prepared by the World Bank, namely the World Governance Indicators (WGI) and the Business Environment and Enterprise Performance Survey (BEEPS).

The CPI (Transparency International, 2015) utilizes corruption-related data from both expert and business surveys conducted by independent and reputable institutions, including the World Bank. This composite index ranks countries in terms of the degree of perceived corruption by both public officials and politicians. In the 2015 CPI the countries with the *least perceived* corruption were Denmark, Finland, Sweden, and New Zealand, while the countries with the highest perceived level of corruption were Somalia, North Korea, Afghanistan, and Sudan. Given the lack of uniformity about what constitutes corruption, one could argue that it is inappropriate to rank countries since the rules of the game are different in each country. The CPI has been criticised that it “embeds a powerful and misleading elite bias” and is not an accurate corruption measure⁵.

The World Bank Institute’s WGI assesses six dimensions of governance for 215 economies: (a) voice and accountability, (b) political stability and absence of violence, (c) government effectiveness, (d) regulatory quality, (e) rule of law, and (f) control of corruption. The WGI includes several indicators that measure the extent of public power and state capture and includes more data sources than CPI, but it does not provide information about trends in global averages (Kaufmann, Kraay, and Mastruzzi 2009:22) and it is not an annual index.

Finally, the BEEPS measures private sector perspective across 20 nations of Eastern Europe and Central Asia. An obvious limitation of this indicator is the size of the survey sample and its limited country coverage. In summary, each of the corruption indices has its weaknesses and, therefore, utilizing more than one indicator would be a wise ap-

⁵ *The Guardian* (2013) ‘Is Transparency International’s measure of corruption still valid? Critics say the NGO’s Corruption Perceptions Index conveys an “elite bias” and doesn’t show evidence of actual corruption’: <https://www.theguardian.com/global-development/poverty-matters/2013/dec/03/transparency-international-measure-corruption-valid>[accessed 21 August 2013].

proach to take.

2. *Consequences of corruption*

According to the World Economic Forum's "Global Agenda Council on Anti-Corruption & Transparency 2012–2014", the cost of conducting business worldwide is increased by 10 percent due to corruption. Both the IMF and the World Bank have identified corruption in general and public sector corruption in particular as the greatest obstacles to social and economic development (Blackburn and Forgues-Puccio 2007). Along the same lines, according to USAID (2005),⁶ corruption undermines business success but also contributes to poverty, inequality, crime, and insecurity. The economic effects of corruption are likely to include a reduction in public revenue and an increase in public spending as well as an increase in income inequality because well-positioned persons can exploit government activities at a cost to the rest of the population (Tanzi 1998, 582–583). By diverting resources for critical services like education, clean water, and health care into the pockets of dishonest government officials, corruption reduces income levels, educational attainment,⁷ and rate of growth, corruption perpetuates the cycle of poverty in many countries and impedes progress (Eicher, Garcia-Penalosa, and Van Ypersele 2009; Hills, Fiske, and Mahmoud 2009). A basic reason why corruption increases poverty is because it reduces the earning potential of the poor (Tanzi 1998, 583).

Regarding the interaction between corruption and political instability on the one hand and policy formation on the other, Fredriksson and Svensson (2003) found that corruption reduces the stringency of environmental regulations, but the effect disappears as political instability increases. Mauro (1996) argued that corruption lowers foreign investment because it has the same effect as a tax, it also reduces the productivity of public investment and a country's infrastructure; and it reduces expenditure for operation and maintenance. Anpkhin and

⁶ Cited by Branco & Delgado (2012, 363).

⁷ The relationship between education, output levels, and the level of corruption, however, is non-monotonic.

Schulze (2009) found that a lack of trust in the ability of the state and market institutions to reliably and impartially enforce law and the rules of trade also hinders productivity and investment in innovation and entrepreneurship. Gyimah-Brempong (2002) reported that corruption is positively correlated with income inequality and also reduces economic growth directly and indirectly through lessened investment in physical capital. Using data from the World Income Inequality database, Ashiku (2011) supported other researchers by reporting that high and rising corruption widens the gap between the rich and the poor and increases the number of people in poverty by reducing economic growth. Ashiku concluded that corruption enriches a small part of the population at a cost to the whole society and therefore leads to greater income inequality. Finally, income growth and increased inequality indicate that corruption has a greater adverse effect on the poor than the rich in developing countries.

3. Corruption and financial crisis

Concerning the link between corruption and the global financial crisis, in his 2009 article in *Forbes*, Daniel Kaufmann (2009) maintained that one of the causes of the latter was the element of *state capture* or just *capture* (i.e., high-level political corruption) in the systemic failures of oversight, regulation, and disclosure in the financial sector. 'Capture' refers to cases in which powerful corporations or persons exploit "the regulatory, policy and legal institutions of the nation for their private benefit" through bribery of high-ranking officials or by lobbying (Kaufmann 2009). Political corruption has been neglected as researchers have focused on petty or administrative corruption, with a notable exception of Heywood, 2015. The importance of capture in the etiology of financial crises led Kaufmann (2009) to argue that the study of corruption ought to include acts that, strictly speaking, are legal but bend the rules of the game. Kaufmann in 2004 examined the level of corruption in a country based on how widespread capture was, creating an index of "legally corrupt" manifestations. Using Kaufmann's ranking, in 2003, the United States came 53rd instead of 18th on the basis of

Transparency International's ratings. Kaufmann's (2009) view that the study of corruption ought to include acts that may be legal but bend the rules is of relevance because in many cases the elite and wealthy can behave legally but unethically, twisting the rules for their own vested interest.

Fraud and Corruption Detection and Prevention

The auditing profession has been criticized and auditors have been sanctioned for failure to: (a) gather sufficient competent evidence, (b) exercise due professional care, (c) exercise a sufficient level of professional skepticism, and (e) obtain evidence related to management representations, (McKenna 2013). William Boynton and Raymond Johnson (2005) have reported that since the fall of Enron, auditing standards had been revamped to re-emphasize the auditor's duty to detect fraud (see AICPA 2002; IFAC 2009). Financial statement users in many countries believe that auditors ought to have a primary audit responsibility to detect all irregularities (Epstein and Geiger 1994), sustaining (to audit firms' likely disappointment) what is known as the "expectation gap" concept. In this context, Porter (1997) argued that users' expectations are beyond what is reasonably expected by common law and by the auditing profession. Porter's argument remains valid twenty years later.

Unique skills are required to detect and prevent fraud and impending corporate failures. In carrying out an audit and assessing the risk of fraud, auditors must exercise reasonable skill and care (which includes professional skepticism) and assess the client's integrity. If they fail to do so, they are legally liable. However, unless auditors are provided with the skills and knowledge necessary to perform their role as prescribed, it is unfair to expect them to detect illegal acts, including fraud, and it would be unreasonable to expect them to detect corruption. Auditors may have a duty in terms of other legislation to report any illegal activities they uncover or come to suspect in the course of their work (Labuschagne and Els 2006), but they are not required to consider the risk of corruption unless specific legislation calls for it.

We see that the external auditor's role in detecting fraud has become more complicated and controversial over the years, but in addition the auditor's capabilities have been called into question (Fraser and Pong 2009). Furthermore, compared to small audit firms, large ones are better resourced, more independent, in a better position to resist pressure from a client, stricter in issuing opinions (De Angelo 1981), but more likely to be sued. Consequently, large accounting firms will ensure a quality independent audit service.

External auditors need to undertake discussions with stakeholders and get involved in "dirtier data-processing" (Fraser and Pong 2009, 145). However, due to the nature of the audit work and the evolution of external auditing (Krambia-Kapardis, 2015), auditors are interested in fraud or theft of assets but not corruption, which may be a feature of a company's culture. Corruption in the private sector can take place, for example, if management bribes a government official; external auditors would rarely know of the offense and consequently would be unable to detect or report it (Khan 2006).

The responsibility for detecting and preventing fraud and corruption falls on the Board of Directors and the Internal Auditors. The Institute of Internal Auditors (2009) acknowledges that management and the Board are ultimately responsible for fraud deterrence, stating that internal auditors can assist management by determining whether the organization has adequate internal controls and fosters an adequate control environment. The Cadbury (1992) Corporate Governance Code stated in paragraphs 2.5-2.7 the role and responsibility of the Board of Directors as follows:

Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship... boards set financial policy and oversee its implementation, including

the use of financial controls, and the process whereby they report on the activities and progress of the company to the shareholders... The role of the auditors is to provide the shareholders with an external and objective check on the directors' financial statements which form the basis of that reporting system.

Thus, the key principles of accountability, probity, and transparency rest with management, the Board of Directors and indirectly the internal auditors but not the external auditors.

Conclusions

This chapter has argued that, fraud and corruption can contribute significantly to bringing about the collapse of corporations and a financial crisis. While definitions of fraud vary across jurisdictions and attempting to precisely define fraud is problematic, the essential element of fraud is deception. Similarly, there is no universally accepted definition of corruption yet a widely accepted and well-used definition of *corruption* is the one used by the World Bank, which refers to the abuse of public power for private profit. Both fraud and corruption have major consequences for victims and economies as well as society generally and can contribute to a financial crisis and a country's financial cliff.

The responsibility for preventing and detecting fraud and corruption rests with management. Those who are charged with the responsibility of preventing fraud and corruption are the management and the Board of an organization. While financial statement users at times expected that the external auditors ought to be charged with such responsibility of detecting or preventing fraud and corruption, both common and statute law as well as the accounting profession have acknowledged that auditors do not have such skills or the knowledge of the offense and consequently they would be unable to detect or report it. Krambia-Kapardis (2016) recommends in chapter 5 of her book a holistic approach/model in addressing both corporate fraud and corruption.

In an effort to minimize the risk of a financial crisis and a financial cliff for a country, the model proposed addressed and integrates issues

of: (a) ethics and moral values at the level of the individual, (b) corporate governance, corporate social responsibility and ethical progress at the level of the company and (c) civil society participation, political accountability, institutional integrity and ethics in curriculum at the level of the society. Only by investing simultaneously at the three levels, it is argued, can the risk of corruption and corporate fraud be minimized and a financial crisis be averted-undoubtedly a Herculean feat but one worth accomplishing.

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