Corporate Fraud Across the Globe

Larry Li
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To my families, with love, Maria, Zara, and Ryan

—Larry Li

To my parents and children, with love for all of time.

—Adela McMurray

Preface

A series of illegal corporate scandals have rocked the business world with the number of corporate fraud cases growing to unprecedented numbers. It has come to light that many globally respected companies, such as Toshiba, Volkswagen, Olympus, BMW, Commonwealth Bank of Australia, and Mitsubishi, are the perpetrators of fraudulent activity, which shock the business world and hugely impact a firm's reputation as well as the respective country's overall economic and social system. Based on theoretical foundations and evidence-based case studies, this book identifies the foundational motivations underpinning corporate fraud in both developing and developed countries and offers practical solutions in terms of monitoring and potentially preventing future corporate fraud activity.

Operational strategies including reform provide an effective channel for a fraudulent firm's business sustainability yet this notion remains unexplored in the literature. In this book, we argue that the choice of appropriate operational strategies is critical as they serve as an effective channel for fraudulent firms to regain trust from customers and markets, and importantly to re-establish their reputation and enhance the firm's long-term value. We posit that there is no "one-size-fits-all" approach that the choice of operational strategies during the post-scandal period is needed to acknowledge the significance of context such as industry type, economic conditions, legal frameworks, as well as the firm's fraudulent characteristics.

Corporate fraud spans a large area of research; therefore, the book is structured into four dominant themes underpinned by several chapters. Each theme has its own setting and focus. The four themes link corporate fraud to various macroeconomic and organisational aspects including variables such as legal framework, business environment, organisational culture, ethics, governance, accounting standards, and performance. A feature of this book is that the content provides a collection of case studies illustrating positive, negative, outlandish, and eccentric aspects of corporate fraud.

The first theme in the series of the four themes is "The Concept of Corporate Fraud" and provides the foundation to this field and should be read first before reading the subsequent chapters. This is because the first chapter addresses the concept of corporate fraud and how it is defined and classified into types, and this is then followed by the theoretical and empirical justification of corporate fraud. The unique feature of this theme is that the concept of corporate fraud is covered from both the process and outcome perspectives across various cultures and contexts.

The second theme "Corporate Fraud Across Countries and Industries" provides original coverage of the corporate fraud literature across developing and developed countries. To date, this has not been covered in the literature thus providing novelty for the reader to gain insights into the diversity of fraud across global boundaries. For example, areas that are covered are corporate fraud in developing and developed countries, corporate fraud comparisons across various countries and industries illustrating the way in which the concept is interpreted and has an impact, within different cultures and contexts. Finally, and ultimately the evolution of corporate fraud trends is presented from an innovative chronological perspective. All topics are relevant to the business context.

The third theme deals with "How to Prevent Corporate Fraud" and is expanded upon by chapters that address the external factors such as the legal framework in the business environment. The focus then turns to internal factors such as organisational culture and governance. The push and pull of internal and external factors illustrate the complexity of corporate fraud and in particular scandals. The effectiveness of external and internal factors varies and largely depends on the social norm, legal framework, business environment, and the nature of the business.

The fourth and final theme embraces "Bring New Hope to the Business" and demonstrates how fraudulent firms reshape their operational strategies and regain the trust of their customers, investors, and other key stakeholders. This is important for fraudulent firms in the long term but unfortunately, this topic is largely overlooked by the literature. The book addresses this oversight by providing robust coverage in two chapters on developing new operational strategies in organisations and how to regain customer trust. Read this concluding theme last as it generates a renewed thinking perspective and a positive note upon which to conclude the controversial and stigmatised corporate fraud topic.

Melbourne, Australia — Larry Li
Adelaide, Australia — Adela McMurray

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PART I

The Concept of Corporate Fraud

CHAPTER 1

What Is Corporate Fraud?

1.1 Introduction

In recent years, a series of illegal corporate scandals have rocked the business world with the number of corporate fraud cases growing to unprecedented numbers. It has come to light that many globally respected companies, such as Toshiba, Volkswagen, Olympus, BMW, Commonwealth Bank of Australia, Kobe Steel, and Mitsubishi, are the perpetrators of fraudulent activity, which shock the business world and hugely impact on a firm's reputation as well as the respective country's overall economic and social system. This illegal behaviour prompted many publics, clients, and investors to ask the same question: "*What is wrong with the corporate sector?*" Obviously, the existing legal frameworks fail to detect and prevent corporate frauds in advance. The frequency and severity of corporate fraud types vary greatly across industry and country. This has a major impact on their financial performance as the disclosure of scandals differs significantly from one fraudulent firm to another.

Although corporate fraud is a widely discussed issue by policymakers, practitioners, and academics, they have not generally accepted a common definition of corporate fraud—this is why the Corporate Finance Institute (CFI) refers to corporate fraud as "*Corporate fraud consists of illegal or unethical and deceptive actions committed either by a company or an individual acting in their capacity as an employee of the company. Corporate fraud schemes are often extremely complicated and, therefore, difficult*

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to identify". Consequently, "*The victims of corporate fraud are consumers or clients, creditors, investors, other businesses, and eventually, the company that is the source of the fraud and its employees. When it is finally discovered, the company committing the fraud is often left in ruins and forced to declare bankruptcy*".

Corporate fraud has become a household term that can be found in the Investopedia (www.investorpedia.com), where corporate fraud is defined as:

> The illegal activities undertaken by an individual or company that are done in a dishonest or unethical manner to give an advantage to the perpetrating individual or company.

Two key features of corporate fraud are included in this definition. The first is that corporate fraud is normally conducted by either an individual or a company in a dishonest way. In fact, multiple deceptive approaches can be adopted by an individual or a company to offer misleading information to public. We will discuss the deceptive approach details in following chapters. The second feature is that all corporate fraud cases are conducted to reach underserved advantages or financial benefits. This definition therefore identifies the approaches and motivation of conducting corporate frauds from accused parties' perspective. It is, however, this definition does not mention what will happen if the illegal activities are uncovered.

Another definition of corporate fraud can be found on Wikipedia.com, where corporate fraud is treated as corporate crime, specified as following:

> corporate crime refers to crimes committed either by a corporation (i.e., a business entity having a separate legal personality from the natural persons that manage its activities), or by individuals acting on behalf of a corporation or other business entity. For the worst corporate crimes, corporations may face judicial dissolution, sometimes called the "corporate death penalty", which is a legal procedure in which a corporation is forced to dissolve or cease to exist.

This definition describes corporate fraud from approach perspective, but it does not mention the reason of conducting corporate frauds. This is an important issue as this could be the starting point of fraud detection and prevention. However, this definition mentions the consequence after a corporate fraud is disclosed, which can be treated as the direct cost of committing corporate frauds. The cost of corporate fraud is important, as it will prevent the fraudulent parties to have the second thought before taking actions.

The definition of fraud varies across jurisdictions. For example, according to the Association of Certified Fraud Examiners (ACFE) in the US, fraud is "*any intentional or deliberate act to deprive another of property or money by guile, deception, or other unfair means*" (ACFE 2014). In addition, ACFE further classifies fraud into internal and external frauds. Internal fraud is also called *occupational fraud*, which is defined as "*the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the organization's resources or assets*" (ACFE 2014).

In addition, three main categories of internal fraud are corruption (conflicts of interest, bribery, illegal gratuities, and economic extortion), asset misappropriation (cash, inventory, and all other assets), and financial statement fraud (income understatement and overstatement). External fraud contains illegal activities could deteriorate the value of a company, including dishonest vendors bill the company for goods or services not provide, or dishonest customers provide falsified account information for payment, or external threats of security breaches, hacking, theft of intellectual property, etc. The focus of this book is the internal fraud which will be discussed in detail in the following chapters. Section 380 (1) of the Criminal Code of Canada defines fraud as "*Everyone who, by deceit, falsehood or other fraudulent means, whether or not it is a false pretence within the meaning of this Act, defrauds the public or any person, whether ascertained or not, of any property, money or valuable security or any service*". There are two critical components of this fraud definition. First, a prohibited act of deception is detected. Second, observable loss caused by the prohibited act. C35 of the Fraud Act 2006 of England and Wales and Northern Ireland defines fraud via providing false representation, failing to disclose information, and abuse of position.

1.2 More Definitions

The academic literature addressing corporate fraud is extensive, and most studies offer definitions and shed some light on the nature of corporate fraud. Few studies refer to the measurement of corporate fraud. Clinard and Quinney (1973) define corporate fraud as "*offences committed by corporate officials for the corporation and the offences of the corporation itself*" (p. 188). According to Duffield and Grabosky (2001), fraud is "*obtaining something of value or avoiding an obligation by means of deception*" (p. 1), which can be further classified into four categories:

1. Fraud committed by a high-ranking entrepreneurial or insider against interest of shareholders and creditors, such as corruption.
2. Fraud committed by an insider or outsider against interest of a government or client, such as insurance fraud or tax evasion.
3. Fraud in face-to-face interactions targeting a consumer, such as a financial advisor pervade a client to make an unethical investment decision.
4. Fraud committed against a number of victims through either traditional or social media, such as deceptive advertising and share market manipulation.

Coenen (2008) points out that the nature of "occupational fraud", "internal fraud", and "corporate fraud" is fairly similar, because they all apply to a wide range of misbehaviours conducted by employees or insiders. In particular, three essential components of a corporate fraud include a false statement, a victim, and an evidenced loss to the victim. In details, corporate fraud is something like:

1. Violate an employee's fiduciary duties to the organisation.
2. Conducted in a secret and concealed way.
3. Bringing direct and indirect benefit to the committers.
4. Damaging employer's assets, revenue, business opportunities, or reputation.

Wells (2017) provides a broad definition of fraud, referring to "*any crime for gain that uses deception as its principal modus operandi*". More precisely, corporate fraud covers a wide range of illegal activities conducted by executives, managers, and employees, ranging from accounting scandals to disguised theft. In addition, it is important that although all frauds involve some forms of deception, four key elements must be associated with a fraud, including:

1. An evidenced false statement.
2. Acknowledge the fact that the statement was false released.

3. The victim trusts or has no ability to detect the truth of the false statement.
4. The false state leads to the loss of the victim.

Dyck et al. (2021) point out that it is not easy to define corporate fraud precisely. As mentioned in their research paper, the US Security Law defines securities fraud as "*To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading*" (p. 4). The focus of their paper, however, is on the pervasive of corporate frauds related to publicly traded firms, so authors treat corporate fraud primarily as misrepresentation. Although the definitions of fraud vary greatly, the key elements of fraud are fairly consistent throughout all the definitions. These key elements are deception, victims, and underserved advantages or financial benefits obtained via deception.

1.3 The Early Years of Corporate Fraud

If you think corporate fraud is a modern concept, then think again. Historically, investors lost billions of dollars from corporate frauds in the past, and the entire economies had been fundamentally damaged. Unfortunately, history always repeats itself on this matter as most investors tend to have relatively short memory in the stock market. Few famous corporate fraud cases in history are presented as follows.

The South Sea Company Bubble (1720)

Arguably, the South Sea Company scandal was one of the most famous corporate scandals in the history, which shocked the whole British society in 1720. The share price of South Sea Company boomed over £1,000 and then dropped shapely to less than £100 between 1720 and 1721. The loss was so significant, and victims covers all level of the British society, ranging from small investors to celebrities, such as Sir Isaac Newton (Toms 2019). It is estimated that Newton lost roughly £20,000 or much more, the equivalent of $4 million today. Consequently, this scandal has been discussed by public and researchers again and again in subsequent nearly three hundred years, which also triggered a series of legislative response to the frauds (Fig. 1.1).

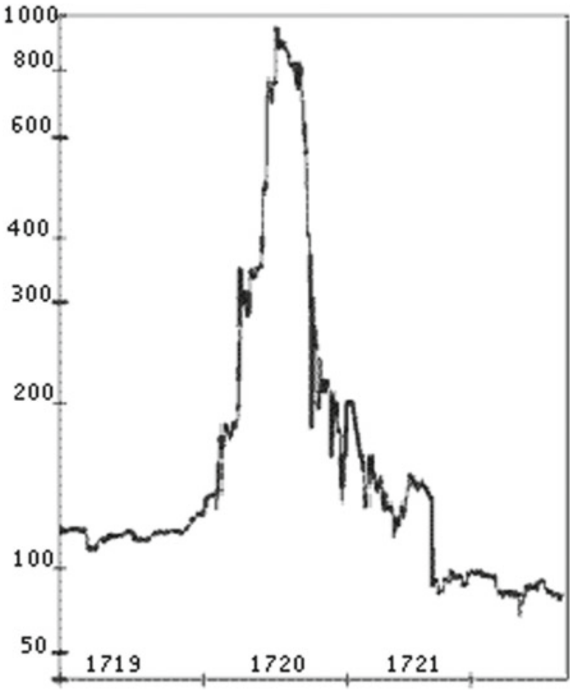

Fig. 1.1 Share price of South Sea Company (*Source* Wikipedia)

What was the South Sea Company, and what actually happened? The South Sea Company was originally founded for international trade in 1711, and investors' confident was dramatically lifted up as King George I of Great Britain became governor of the company in 1718. In addition, the company agreed to take over 32 million pounds of Britain's national debt in exchange of the monopoly rights to trade with South America, but never made much from those activities. As expected, the price of South Sea stock increased dramatically from around £120 in January 1720 to overall £1,000 in August 1720. At its peak, the market value of South Sea was around twice the value of all land in England (Chancellor 2019). After September 1721, the market lost its confidence to the company, evidenced by the free-falling share price, and reached £124 in December 1721. The crazy price movement of South Sea stock made the investment losses to countless investors, including British government and Sir

Isaac Newton. The market crash provoked huge public outcry and forced government to launch an official investigation about the causes of this event and found out that at least three carbon members and multiple South Sea directors were involving bribery and share price speculation. The South Sea Company itself survived until 1853 and sold most of its rights to the Spanish government in 1750. The South Sea bubble contains features which were common to many other corporate scandals in subsequent years. Although definitions of corporate fraud vary greatly, most common features include corruption, bribery, embezzlement, and market manipulation, which can all be observed in South Sea bubble.

The City of Glasgow Bank Scandal (1878)

On 2 October 1878, the City of Glasgow Bank (CGB) stunned the whole country when its directors announced to close the bank. Just in June 1878, the book reported that the bank has 133 branches with deposits of £8m, and declared a 12% dividend (Swinfen 2016). As expected, the whole country was devastated. After months of investigation, it was revealed that the bank had net liabilities of over £6m (= roughly £500 million at 2005 prices). In addition, the bank involved serious account misstatements to cover the losses from bad loans and speculative investments granted by negligent directors. As expected, these terrible business decisions brought significant losses to shareholders and the whole societies (Lee et al. 2008; Toms 2019). What's even worse was that CGB was not a limited company, therefore, all 1200 shareholders were directly responsible for the debts of CGB, that means the shareholders would be held liable for £2,750, per £100 share held, which was a huge sum of money in those days.

The collapse of CGB had a significantly negative impact on the Scottish society. All CGB shareholders and their families greatly suffered, and only few shareholders managed to avoid bankruptcy. In addition, hundreds of small firms were out of business due to this disaster, and the general public has lost their faith in financial institutions in Scotland. All directors of CGB were found guilty of falsifying and fabricating the balance sheets of the bank and were given various imprisonment each. The CGB scandal called for the urgent need for a better accounting and audit standard, which led to a rapid increase in using professional auditors. Subsequently, the Institute of Chartered Accountants in English and Wales was founded in 1880 for promoting the accountancy professions and improving the quality and trustworthy of this profession in UK (Toms 2019). Another positive result of this scandal was the increased popularity of limited liability, especially for banks. Fortunately, depositors did not suffer as other banks accepted their deposits guaranteed by shareholders' liability.

Enron Scandal (2001)

Enron was the 7th largest company in US before the fraud was discovered, with approximately 22,000 employees globally. In addition, Enron was nominated by *Fortune* magazine as "American's Most Innovative Company" for six consecutive years between 1996 and 2001. However, Enron shocked the world when it filed for bankruptcy on 2 December 2001. The price of Enron stock was traded around US $90 per share before the fraud was uncovered and dropped to 26 cents before delisted by the NASDAQ. No surprising, investors and Enron employees lost US 74 billion dollar from the biggest bankruptcy recorded (US $63.4 billion in assets) at the time (Benston and Hartgraves 2002).

The story of Enron Scandal was very simple. Based on the utilisation of so-called creative accounting techniques, off-balance sheet transactions, and special purposes vehicles (SPVs), Enron was able to hide huge amount of debt and toxic assets from investors and creditors. For example, Enron would claim the projected profit on its books from a newly established power station before any revenue was generated. If the revenues from the new power station were not as good as projected figures, then the company will transfer the asset to the books of a separate entity where the loss would not be reported on Enron's financial statement. Though transactions between Enron and SPVs capitalised by Enron stock, the company could borrow money from banks without affecting its leverage ratio on paper. As a result, Enron had successfully hid billions of dollars of bad debt via accounting tricks and inflated the company's financial performance as well as share price.

Arguably, Ms Sherron Watkins was the first Enron employee raised her concerns of accounting improprieties, which led to a series of events eventually stunned the world. On 16 October 2001, Enron restated its previously reported net income for the years 1997–2000 by reducing US $544 million and reduced its shareholders' equity by $1.2 billion. On 8 November 2001, Enron admits it has been inflating its income by around US $586 million since 1997. Another major player involved in Enron

Scandal was Enron's accounting firm "Arthur Anderson", which was one of the Big Five accounting firms at the time. Arthur Anderson was criticised for endorsing Enron's annual report despite its poor accounting practices. It was reported that Andersen was paid US $46.8 million in 1999, $38 million in 2000, and between US $50 and $55million in 2001 by Enron for its auditing and other consulting services (WSJ 2002). Therefore, it is hard to believe that Arthur Anderson could provide objective and unbiased auditing services to Enron. Subsequently, Arthur Anderson was charged for illegally destroying documents relevant to the Security and Exchange Commission (SEC) investigation, and it was eventually out of business in 2002.

The fall of Enron has raised everyone's concern on the quality and reliability of business financial practices at the time. As Mr. Harvey Pitt, the chairman of SEC, pointed out "*under the current quarterly and annual reporting system, information is often stale on arrival and mandated financial disclosures are often 'arcane and impenetrable*" (Connell 2017). Consequently, the Sarbanes–Oxley (SOX) Act of 2002 was passed in response to the Enron scandal and the collusion between Enron and accounting firm Arthur Andersen, aiming to offer better investors protection via improving the accuracy and reliability of corporate disclosures in financial statements and other documents. It is also worth to mention that the two key persons in the centre of this scandal were CEO Jeff Skilling and former CEO Ken Lay. Mr. Skilling was convicted on 18 counts of fraud and conspiracy charge in 2006 and eventually sentenced to 24 years in prison. Mr. Lay was found guilty on six counts of fraud and conspiracy and four counts of bank fraud. He died about a month after the trial, and his conviction was vacated (Stevens and Haag 2019). Ms Sherron Watkins was hailed as a whistle-blower of Enron scandal and selected as one of three "Persons of the Year 2002" by *Time* magazine.

WorldCom Scandal (2002)

WorldCom was the second-largest telecommunications company in US before its bankruptcy. In addition, WorldCom has been frequently mentioned in corporate fraud literature as this company was famous for inflating its assets by as much as US $11 billion (Siegel 2019). In addition, the company was found to inflate US $3.8 billion improperly reported earnings before taxes between 1999 and 2002, which made the biggest accounting scandal ever in the history. All these deceitful accounting activities were conducted mainly based on the instruction from the Mr. Bernard Ebbers, the CEO of WorldCom to beat the market expectation from Wall Street. Consequently, at the peak of the dotcom bubble, the market value of WorldCom reached US $175 billion.

If Enron scandal was covered by its complex partnerships and transactions with SPVs, then what WorldCom did wrong was very straight forward. There were two basic accounting concepts associated with WorldCom scandal: business expenses and capital expenditures. These two different types of business cost were treated differently when preparing the income statement. In general, business expenses, such as business overhead or direct labour cost, should be considered as the part of business cost of the current accounting period and, therefore, are directly deducted from revenue. In contrast, capital expenditures are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, or equipment. The capital expenditures can be capitalised, that means the total capital expenditures can be allocated as expenses in the income statement over the period during which physical assets are expected to provide economic benefits. What happened to WorldCom was very simple. The company capitalised its business expenses with the intent of making the company look more profitable. Based on this approach, the company successfully inflated and exaggerated its profits by around US $3 billion in 2001 and US $797 million in Q1 2002, reporting a profit of US $1.4 billion instead of a net loss (Kaplan and Granelli 2002).

Eventually, all these wrongdoings were detected by a group of internal auditors in 2002 as they could not find any invoices or documentation to back up a US $500 million charge for computer equipment. This triggered a deeper investigation of the company's book where bigger problems were uncovered. Ms Cynthia Cooper, the formal vice president of internal audit unit at WorldCom, played an important leading role in this process. Cooper and her team briefed the company's audit committee and board of directors in June 2002. It is also worth noting that Arthur Anderson was the external auditor of WorldCom. The rest of the story looks very familiar. SEC launched its investigation, WorldCom filed for bankruptcy in 2002, and investors experienced huge loss. Ebbers was convicted on nine counts of securities fraud and sentenced to 25 years in prison in 2005, and the former CFO Scott Sullivan received a five-year jail sentence. Ms Cynthia Cooper was named as one of three "Persons of the Year 2002" by *Time* magazine.

Madoff Investment Scandal (2008)

Arguably, the most shocking news during the global financial crisis period was the collapse of the Bernard L. Madoff Investment Securities. Before the global financial crisis, Mr. Bernard "Bernie" Madoff was a very influential and respected figure on the Wall Street. He was the founder and chairman of the Bernard L. Madoff Investment Securities, which was the 6th largest market maker in 2008. In addition, he was the chairman of the NASDAQ stock exchange. However, Bernard "Bernie" Madoff was the person responsible for the largest Ponzi scheme in history. The Ponzi scheme, which likely run in decades, eventually costed billions of dollars from thousands of investors. The fund's last statements indicated it had US $64.8 billion in client assets. Many investors were cheated by Madoff, including big instructions, such as Banco Santander, HSBC, Royal Bank of Scotland, Korea Teachers Pension, and many celebrities, such as famous victims of this scandals, include Larry King, Steven Spielberg, Kevin Bacon and Kyra Sedgwick, John Malkovitch, Ira Rennert, and Elie Wiesel (Dangremond 2017; Carlson 2021).

Again, how did he manage to do that? Madoff's trick was very simple. He put all clients' money into a single bank account and used this account to pay investment returns to existing clients or whoever wishes to redeem their investment. The superior investment return and his reputation helped his company attract tens of billions of dollars from investors all around the world. In addition, Madoff was trying to cultivate an image of exclusivity of his company by turning clients away, which made him more attractive to investors. However, the party time for Madoff ended in 2008 when the market was hit hard by the global financial crisis. Many investors wanted to withdraw their money, but Madoff did not have enough money to make the payment. Under escalating pressure, Madoff had no choice but to confess that his advisory business is basically a big Ponzi scheme.

In 2009, Madoff pleaded guilty to charges of eleven federal felonies and was sentenced to 150 years in maximum security prison and US $170 billion restitution. He passed away in 2021 in federal prison due to nature causes at the age of 82. Originally, the size of the fraud was estimated around US $65 billion. Along with the investigation and recovery process, the total loss of this fraud could be around US $12–$20 billion and depends on the calculation method. There is no winner from this scandal, even for Madoff himself. Many Madoff family members have been investigated, including his brother, two sons, niece, and wife. His brother was