

Understanding the Demand and Supply Equations of Corruption and Fraud

An insight into the Corruption and Fraud by the private sector in India



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LIST OF ABBREVIATIONS

AAER	Accounting and Auditing Enforcement Release
ACB	Anti-Corruption Bureau
ACFE	Association of Certified Fraud Examiners
AICPA	American Institute of Certified Public Accountants
AO	Assessing Officer
CBDT	Central Board of Direct Taxes
CBI	Central Bureau of Investigation
CCI	Competition Commission of India
CEO	Chief Executive Officer
CFO	Chief Financial Officer
COSO	Committee of Sponsoring Organizations
CVC	Central Vigilance Commission
ED	Enforcement Directorat.
EOW	Economic Offences Wing
FERA	Foreign Exchange Regulation Act
GDP	Gross Domestic Product
ICICI	Industrial Credit and Investment Corporation of India
IDBI	Industrial Development Bank of India
IFCI	Industrial Finance Corporation of India
IICA	Indian Institute of Corporate Affairs
IMF	International Monetary Fund
IP	Integrity Pacts
IPC	Indian Penal Code
LIC	Life Insurance Corporation
MCA	Ministry of Corporate Affairs
MLM	Multi-Level Marketing Companies
MRTTP	Monopolies and Restrictive Trade Practices Act
NACS	National Anti-Corruption Policy
OECD	Organization for Economic Co-operation and Development
PC Act	Prevention of Corruption Act
PCAOB	Public Company Accounting Oversight Board
RBI	Reserve Bank of India
RTI	Right to Information Act
SAT	Securities Appellate Tribunal
SEBI	Securities Exchange Board of India
SEC	Securities Exchange Commission
SFIO	Serious Fraud Investigation office
TI	Transparency international
UN	United Nations
UNCAC	United Nations Convention Against Corruption
US	United States
UTI	Unit Trust of India

TABLE OF CONTENTS

FORWARD BY GEORG KELL	8
INTRODUCTION BY S. RAMADORAI	9
EXECUTIVE SUMMARY	10
AN INTRODUCTION TO CORRUPTION	13
AN INTRODUCTION TO FRAUD	19
CORRUPTION AND FRAUD IN CORPORATE INDIA	24
RESEARCH DATA AND ANALYSIS	27
STAKEHOLDER PERSPECTIVES ON PRIVATE SECTOR FRAUD IN INDIA	42
FRAUD AND CORRUPTION: MECHANICS AND PERSPECTIVES	48
DETECTING FRAUD AND CORRUPTION: CHALLENGES FOR OVERSIGHT	54
GOOD PRACTICES FOR MAINTAINING ETHICAL BEHAVIOUR	58
CONCLUSIONS	67
ENDNOTES	70

FORWARD BY GEORG KELL



It has been nearly 10 years since the UN Global Compact adopted the 10th Principle, calling on business to work against corruption in all its forms, including extortion and bribery. The 10th Principle not only sends a strong signal on the role of business in the fight against corruption, but also emphasizes the importance of ethical principles in creating healthy markets. Where corruption is pervasive, economies cannot function properly, efficiently or fairly. To reduce this cost to doing business, an increasing number of companies have already introduced measures to prevent corruption and respond more proactively to incidents.

The Global Compact Network India and its business participants play an instrumental role in advancing the anti-corruption agenda through their commitments, dedication and action. As a partner of the Siemens Integrity Initiative, the Global Compact Network India has worked with hundreds of companies since 2011 to discuss challenges and opportunities to enhancing transparency in their interactions with governments and other stakeholders. In 2013, Indian companies have shown their enthusiasm for the Call to Action: Anti-Corruption and the Post-2015 Development Agenda, a global campaign which is mobilizing companies to urge Governments to integrate anti-corruption into the future development goals. I hope that more Indian companies will join this campaign.

Despite progress made in this area globally, more efforts are needed to create a level playing field where ethical and responsible businesses are rewarded; combating fraud is an important step towards this. Corruption and fraud are closely linked – as fraudulent practices are often found where tolerance to corruption exists.

In this regard, I am pleased that the Global Compact Network India and Thought Arbitrage Research Institute have developed this report. The publication showcases a robust set of institutional watchdogs to monitor and investigate corruption and fraud in India, and highlights how companies can more proactively engage to address corruption and fraud. The report aims to stimulate dialogue among stakeholders and galvanize business leaders to advance ethical corporate practices and eradicate corporate fraud.

The Indian private sector has shown immense potential to foster a transparent and sustainable economic environment. I am optimistic that we can collectively triumph against corruption and fraud by forging a collaborative relationship between government and business, as emphasised in this report. I hope that this report is found to be an effective tool by various stakeholders to encourage corporate leadership to scale up its efforts to create a transparent, ethical and thereby level-playing field.

Georg Kell
Executive Director
UN Global Compact

INTRODUCTION BY S. RAMADORAI



I am delighted to introduce “Understanding the Demand and Supply Equation of Corruption and Fraud”, compiled by the “Thought Arbitrage Research Institute” and Global Compact Network, India. This is a piece of work that gives the reader a very good insight into instances of corruption and fraud in India’s corporate sector.

The effects of fraud and corruption can be far reaching. As pointed out in the report, fraud and corruption affects not just the image of a company, but often leads to discontinuation of business, resulting in erosion of wealth at many levels. When ‘thrown off balance’ due to instances of unethical activity in their midst, companies with high standards of corporate governance and conduct always manage to take strict action against those found guilty, and bring them to book. The report highlights this need for decisive action in many places.

A good deal of research has gone into compiling this report. It takes an in-depth look at about 100 major corporate frauds that have occurred in India’s private sector over the past 15 years, and puts forth practical solutions that would be useful for corporate houses, to both prevent, as well as manage, corruption and fraud.

The report provides a detailed analysis of frauds - their types, means, frequencies, etc. It examines the weaknesses or inefficiencies of regulators that sometimes lead to their failure to predict and prevent corporate frauds. But what is particularly valuable to read about are the various possible fraud management solutions, with special emphasis on organizational control and code of conduct.

Having been a member of the Tata Group for over four decades, I have been fortunate to be part of a system, where the ethical practice of business is a ‘way of life’. Still, it was felt necessary by the Group to codify this belief formally,

resulting in the publishing and adoption of the Tata Code of Conduct in 1998.

As we all know, a chain is as strong as its weakest link! Irrespective of their history or good intentions, all companies need to place internal controls, sound monitoring mechanisms, risk assessment and risk management processes in place. This report shares practices followed by companies like Tata Chemicals, Siemens, Infosys, GAIL, etc. It explains how these companies are now striving towards developing various formal (and informal) systems of governance to improve overall organizational strength. And, these companies are not just relying on improving their internal systems, but are also trying to influence the overall corporate environment by promoting collective corruption-fighting mechanisms through social groups, civil society, etc.

Clearly, while a lot is being done by reputed businesses to promote good corporate governance, a lot still needs to be done to improve the corporate environment of the country, in terms of business ethics.

The report points out that of the 100-odd cases of fraud studied, most occurred in medium-sized companies with revenues around Rs. 200 cr. A pointer to where reform and action is needed. In a country like India, solutions could range from strengthening regulatory mechanisms and our legal system, to ensure swift redressal. Punitive action on the guilty, successfully implemented, could be a strong deterrent to future criminal acts.

In our technology-driven age, we need to see increasing use of IT-based solutions and analytics that could not only detect fraud and corruption, but also help recognize risks even before the fraud is committed. The power of popular social networks could be powerfully leveraged to spread awareness about corrupt practices, and as a platform for ‘whistle-blowers’.

Taking on board the recommendations in the report would be no ‘guarantee’ against future attempts at fraud and corruption. Intelligent, but crooked individuals, will always seek, and often find, new ways to ‘beat the system’.

But useful advice suggested in the study will certainly go a long way to reduce the probability of their occurrences.

I believe that this report provides useful lessons and ideas to help businesses undertake their activities ethically, in a highly dynamic and challenging business environment.

S. Ramadorai
Vice Chairman
Tata Consultancy Services

EXECUTIVE SUMMARY

Corruption and Fraud

In one way or another, people all across the globe get impacted by fraud and corruption. This study is an attempt to understand corruption and fraud, its multiple facets, sources, nuances and related complexities.

Corruption is commonly understood as the abuse of entrusted power to extract private gain at the costs of society by diversion of legitimate funds. Business is both the cause and victim of corruption. Corruption can take various forms: political or bureaucratic; grand or petty; isolated or systemic and private sector corruption.

Corruption thrives in a world of opacity caused by a maze of rules, discretion of governmental authority and the lack of accountability or consequences for actions by an official. When information asymmetry persists among the general public, it results in a low level of awareness and demands for bribes are easily fulfilled. Further high taxation, multiple regulations, layers of authorization, numerous subsidies and other spending decisions of government provides impetus to corruption. Corruption also thrives in conditions of low bureaucratic quality, inadequate public sector wages, low institutional controls, poor leadership standards, vague rules, ineffectual laws, processes and their unimpressive implementation.

Corruption includes instances of fraud, fraudulent behavior, receiving bribes or other benefits. Corruption and fraud are intricately linked, as a corrupt environment makes it easier to perpetrate frauds; equally, frauds help generate illicit funds which can be used to win favours by paying bribes or for other quid-pro-quo.

Fraud is mostly defined as a wilful act of deception or misrepresentation resulting in an unauthorized benefit to the perpetrator or others. Asset misappropriation, conflict of interest, bribery and extortion, and manipulation of financial statements are common ways for perpetrating fraud.

The public procurement system is very prone to fraud with prevailing malpractices of cartel formation accompanied by collusive bidding and rigging. In private sector too, the risk of fraud is pervasive across all enterprises and countries irrespective of their sizes.

Research Data and Analysis

The risk of fraud is an inherent risk in all financial statements issued by companies all over the world and India is no exception to this. An in-depth analysis of the major corporate frauds (100 in number) that occurred over the last 15 years¹ have been undertaken in this study to understand their underlying factors, *modus operandi* and outcomes. The analyses of fraud cases in this study is limited only to cases in private sector companies, perpetrated by promoters and management commonly referred to as 'management fraud' and excludes employee frauds. Some key findings from data analytics of the study are:

- The occurrence of fraud is almost equally poised between public and private limited companies
- Most of the companies have medium scale of operations with the average revenue size of less than Rs 200 crores. Further, in 80% of the cases, the size of the fraud was less than Rs 200 crores. However, the average revenue size of these companies has increased 7.25 times in the period after 2009, exposing larger number of stakeholders to risks of corporate failure
- Fraud risk is pervasive across all the industry sectors with manufacturing sector accounting for one out of three cases highlighting the need for appropriate fraud policies across all the sectors
- Significant spurt not only in the number of fraud cases but also in their size after 2009 with an average size of fraud almost doubling since 2009
- Most fraudulent transactions were designed to either siphon of the companies funds by promoters or top management or to defraud government/ investors/ lenders. One of the key contributing factors for corporate fraud in India is the control and concentration of promoters, whether families or MNC's at the helm of affairs. Such controls over all aspects of business are often abused for personal gains at the cost of other stakeholders

¹ Our sample comprised of the cases which have been investigated by the Serious Fraud Investigation Office (SFIO), the Central Bureau of Investigation (CBI) and the Income Tax department on the basis of information available in public domain.

- Fraud techniques used in last 15 years have not undergone much sophistication. Most of frauds in our study perpetrated through recording of assets at a value higher than their fair value or alternatively by a web of book entries through related party accounts to embezzle. This also points towards existence of control weaknesses that give perpetrators of the fraud an 'opportunity' to commit such a fraud
- No significant cases have come to light where the auditors have been able to detect such fraud in the course of their audits, reflecting poorly on the watchdogs (i.e. internal, statutory and tax auditors) who take their cues from the gatekeepers i.e. regulators. The auditors should have been the first ones pointing out most of these frauds in the financial statements because the schemes do not seem to be too sophisticated or complex
- Number of frauds in the our study are equally distributed among firms audited by the Big 4 and Non-Big 4 auditors indicating that detection of fraud is hard even for large auditing firms
- Presence of earnings management can be construed to be a potential indicator of presence of financial statement fraud
- Majority of the companies involved in fraud have either been liquidated or business discontinued or are continuing at reduced levels with market valuations drastically reduced
- The study cannot comment conclusively on the adequacy or otherwise of the penalties/fines imposed due to lack of adequate public information. There seems to be an inadequate enforcement of laws and deterrence for committing frauds. These frauds seem to be carried out with impunity as the chances of getting caught are minimal and the quantum of fine and punishment is not a valid deterrence ensuring them to retain the spoils of the fraud as personal wealth.
- Effectiveness of Clause 49 of Listing Agreement (corporate governance code for all for public listed companies) covenants on fraud occurrence, detection and prevention is very limited

The study also conducted a limited review of violations of securities trading and related laws from 1998 to 2012 that have resulted in convictions and fines as a result of prosecution cases filed by SEBI in order to understand the effectiveness of the prosecution mechanism and whether it acts as a deterrent for the violators. In case of breach of SEBI laws the consequent fines or length of sentences is not a deterrent or is punitive for defaulters. In fact given the paltry nature of fines or the facile length of sentences, it may even make it to be profitable for offenders to violate securities trading or corporate laws in India.

Detecting Fraud and Corruption: Challenges for Oversight in India

The economic liberalization started in 1991 has reduced the incidence of corruption with the dismantling of an elaborate system of inspectors set up under some of the draconian outdated legislatures. The Government of India initiatives, such as RTI Act 2005 and on e-governance, constructive role played by the CAG of India, and greater judicial involvement have been some of the steps towards coping with widespread corruption prevalent in the last century in India. However, this does not mean that corruption has disappeared from India. The decrease in 'petty' corruption has been more than compensated by the rise in 'grand' corruption as recent scandals have shown. It is also true that liberalisation has provided even larger opportunities to corporates who are more than willing to use both fair and unfair methods of winning favours with the government.

Corporate conduct in India is overseen by multiple gatekeepers who act on different aspects of business transactions. There are multiple regulators such as the Securities and Exchange Board of India, the Reserve Bank of India and the Institute of Chartered Accountants of India that are responsible for enforcement of corporate laws. Gatekeepers operate in an interdependent rather than an independent manner and it is important to have a certain degree of collective responsibility among all gatekeepers to harness their total capacity to deter wrongdoing. These regulators have been bestowed with the powers to, investigate, issue of summons, prosecute and levy penalties. However this structure has led to major regulatory overlaps and gaps.

Good Practices for Maintaining Ethical Behaviour

Corruption affects the cost of doing business, particularly in developing countries. It is widely recognized that corruption takes place with the tacit cooperation of both businesses and government.

There are numerous tools and practices available to business to prevent and/or control fraud and corruption at organizational level, such as, setting up efficient internal control systems; establishing code of conduct for employees and top management; setting tone at top management for zero tolerance towards fraud; instituting fraud risk assessment programme; establishing whistle blower hotline; enforcing a deterrence mechanism; formulating detection plan; setting up audit committee and enhancing role of internal auditors.

Certain improvements in external factors in the form of healthy governance, effective prevention and robust prosecution and recovery mechanism by governments/enforcement agencies can provide the necessary impetus in fraud prevention and detection endeavours. Collective measures include the role of social groups, civil society and other organizations in improving fraud and corruption environment. Other measures relate to international cooperation for greater transparency and sharing of resources and best practices in governance mechanism in laws and regulations.

Way Forward

Going forward a number of players in corporate India would need to decide whether they will continue to rationalize corruption and fraud as a way of doing business or whether they will adopt more sustainable business practices.

There cannot be a single silver bullet solution to curb corporate fraud and corruption; the current study is an attempt to look at the evidence available and compile various facts and nuances surrounding this complex issue. It is an attempt to move away from the emotive appeal of the anti-corruption and anti-fraud stand to explore the subject dispassionately so that a platform of dialogue and possible solutions can be created.

The discussions and dialogue generated by the report could lead to a number of complementary and supplementary measures required both inside of an organization and outside. A mix of regulatory and enforcement solutions and initiatives can very quickly move the current mind-set of gloom and doom to an environment, which is suitable for more transparent and sustainable business. The high confidence created in business and society would help invigorate economic growth and development of society at large.

“Corruption afflicts all countries, undermining social progress and breeding inequality and injustice. When desperately needed development funds are stolen by corrupt individuals and institutions, poor and vulnerable people are robbed of education, healthcare and other essential services.”

UN Secretary General, Mr Ban Ki-Moon²

AN INTRODUCTION TO CORRUPTION

Definitions, Causes and Effects

The last few years have seen large scale demonstrations by citizens across the world. If the ‘Arab Spring’ has seen popular and violent uprising against long standing totalitarian regimes, there have been almost peaceful protests commonly referred to as ‘Occupy Wall Street’ demonstrations in the USA and other parts of the world against the capitalistic system and greed associated with it. These movements have impacted politics, economics and the society around the world and as they continue to reshape the world around us, it is important to understand the core issues that lead to such upheavals.

While the reasons triggering these protests appear to be local and diverse, if we look deeply we will see that corruption has emerged as a common theme in all these protests³.

Corruption is a complex subject with many facets, nuances and a constantly shifting landscape. In some countries, citizens accept corruption as a day-to-day reality with stoic silence, while in others they are determined to fight against it. Some governments merely create an illusion about combating corruption, while others attempt to root it out with various tools at their disposal. In some instances business is a cause of corruption, in others, it is simply a victim of a vicious environment where there is a need to bribe just to survive.

What is Corruption?

The word corrupt has Latin roots. It originates from ‘*corruptus*’ which means ‘to abuse; spoiled’ and ‘*corrumpere*’ which means ‘to ruin; break into pieces; to destroy.’⁴ Therefore it seems that corruption has the corrosive power to destroy the very fabric of civilised life.

The United Nations Convention Against Corruption (UNCAC) was the first binding global anti-corruption instrument. Former UN Secretary General, Kofi Annan, had written in the foreword to the UNCAC that “*Corruption is an insidious plague that has a wide range of corrosive effects on societies. It undermines democracy and the rule of law, leads to violations of human rights, distorts markets, erodes the quality of life and allows organized crime, terrorism and other threats to human security to flourish.*”⁵ UNCAC first entered into force in December 2005 and was ratified by India on May 1, 2011.

The UN Global Compact (UNGC) has adopted Transparency International’s (TI) definition of Corruption - a global civil society movement, which is “*the abuse of entrusted power for private gain.*”⁶ Gain can mean financial as well as non-financial advantages.

The World Bank also defines Corruption in a very similar and straightforward manner – “*the abuse of public office for private gain.*”⁷ It is however, important to note that the World Bank’s definition is a bit narrower as it only considers the public office while considering corruption. The Organization for Economic Co-operation and Development (OECD), defines corruption as “*active or passive misuse of the powers of Public officials (appointed or elected) for private financial or other benefits.*”⁸

OECD observes that corruption can have different definitions, and that also includes fraud and fraudulent behaviour. They state that there are two different types of corruption, one active corruption, “*paying or promising to pay a bribe*”, and other passive corruption, “*demanding or receiving a bribe.*”

UNGC also recognizes that corruption can take many forms that vary in degree from the minor use of influence to institutionalized bribery. Again UNGC uses TI’s definition of bribery i.e. “*An offer or receipt*

2 Message of the UN Secretary-General, on December 9, 2011. <http://www.un.org/en/events/anticorruptionday/sgmessages.shtml>

3 Who pays for corruption? by Kaushik Dutta, Sameer Kapoor & Sumati Rajput. Article published in The Pioneer on September 14, 2012. <http://www.dailypioneer.com/business/94564-who-pays-for-corruption.html>

4 N Handbook on Practical Anti-corruption measures for prosecutors and investigators. Page 23. <http://www.unodc.org/pdf/crime/corruption/Handbook.pdf>

5 The United Nations Convention against Corruption (UNCAC) December 2005.

6 Collective action project business case for public-private dialogue on Anti-corruption and Green Economy. Policy paper by Global Compact Network, India.

7 Helping countries combat corruption. Role of World Bank. (www.worldbank.org).

8 Glossary of Statistical Terms, Organisation for Economic co-operation and development. (stats.oecd.org)

“Corruption breeds in a world of opacity caused by a maze of rules, discretion of governmental authority and the lack of accountability or consequences for actions by an official.”

of any gift, loan, fee, reward or other advantage to or from any person as an inducement to do something which is dishonest, illegal or a breach of trust, in the conduct of the enterprise's business.”⁹

In their study on corruption, Kauffman and Vincente (2005)¹⁰ have challenged conventional definitions of corruption with primary focus on public office and bribery, and private sector being left unscathed. In the author's view, corruption is:

“a collusive agreement between a part of the agents of the economy who, as a consequence, are able to swap (over time) in terms of positions of power (i.e. are able to capture, together, the allocation process of the economy). This is the idea underlying high-level corruption or “influence”, and is broader than the notion of bribery, which corresponds to a particular sharing pattern of the joint payoff from the referred relationship.”

What Causes Corruption?

The World Bank observes that opportunity for corruption, is a function of the size of the rents under a public official's control, the discretion that official has in allocating those rents, and the accountability that official faces for his or her decisions.¹¹ In that regard, World Bank points that the dynamics of corruption by a person holding public office, therefore, can be depicted in a model.

Corruption breeds in a world of opacity caused by a maze of rules, discretion of governmental authority and the lack of accountability or consequences for actions by an official. Studies including those by the World Bank indicate that there are three pillars on which corruption rests; discretionary powers of public officials; opacity in rules and their application; and low deterrence in the form of punishments or consequences.

In the developing world including India, the other reason that feeds corruption is information asymmetry caused by low literacy levels. A common citizen often gets caught in the circle of asymmetry as he is often unaware of his rights and entitlements. This is exploited by a public official who takes advantage of his position even when there is no justification such as having to pay a postman for receiving a remittance sent by relatives or paying a teller for withdrawing one's deposit from a bank.

Vito Tanzi (1998), in an IMF staff paper titled 'Corruption around the World'¹² has identified the following direct causes of corruption:

- (a) Regulation and authorizations;
- (b) Taxation;
- (c) Spending decisions of the Government (including investment projects, public procurement and extra-budgetary spending);
- (d) Providing goods and services below market price (i.e. subsidies);
- (e) Financing of elections; and

9 Collective action project business case for public-private dialogue on Anti-corruption and Green Economy. Policy paper by Global Compact Network, India.

10 Legal Corruption by Daniel Kauffman and Pedro C. Vincente (2005). Page 1

11 Helping countries combat corruption. Role of World Bank. (www.worldbank.org).

12 Corruption around the world by Vito Tanzi (1998). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=882334

- (f) Other discretionary decisions like tax incentives, zoning or acquisition of private land, transactions on government land, decisions on foreign investments, public sector disinvestment and providing monopoly power for export, import or domestic use.

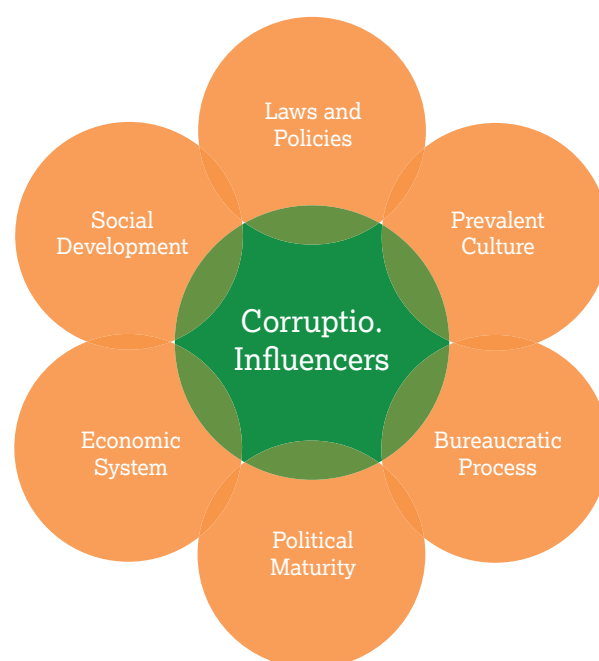
Tanzi¹³ has also identified certain indirect causes of corruption in his paper. These include:

- (a) Quality of bureaucracy;
- (b) Level of wages in the public sector;
- (c) Penalty systems;
- (d) Institutional controls;
- (e) Transparency in rules, laws and processes; and
- (f) Examples of leadership.

These studies have a recurring theme of high bureaucratic or institutional controls, low systems of penalties and lack of transparency in rules and processes to be the key drivers of a corrupt society.

In another IMF sponsored study, Paulo Mauro (1997)¹⁴ highlights other factors that lead to corruption. Prominent among these are the 'natural resource endowments' like oil, gold etc. which may be sold at a very high value as compared to their production cost; and while their sale is usually controlled by government regulations, corrupt officials could help circumvent such controls. The economic incentive for corruption in some cases is so high that it is almost impossible to prevent it, without lowering the incentive.

Mauro also brings out certain sociological factors of corruption, such as, government officials are more likely to do favours to their family members in societies where family ties are strong. The division of society along ethnic and linguistic lines also has been found to be correlated with corruption as was hypothesized by Shleifer and Vishny (1993).¹⁵



Types of Corruption

The World Bank¹⁶ classifies corruption into:

World Bank classification of corruption	
Political & bureaucratic corruption	Grand and petty corruption
Isolated and systemic corruption	Corruption in the private sector

13 Corruption around the world by Vito Tanzi (1998). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=882334

14 Why worry about Corruption ? Paulo Mauro, 1997. IMF. <http://www.imf.org/external/pubs/ft/issues6/issue6.pdf>

15 Shleifer, A., and Vishny, R. (1993). Corruption. The Quarterly Journal of Economics, 599-617.

16 Helping countries combat corruption. Role of World Bank. (www.worldbank.org).

- (a) **Political and bureaucratic corruption:** Political corruption involves abuse of election laws, conduct of elections and campaign finances. Bureaucratic corruption is intrinsic to the way power and discretion are exercised and could involve conflicts of interest. Corruption within government can take place at both the political and the bureaucratic levels, independently or in collusion with each other.
- (b) **Grand and petty corruption:** 'Grand' (i.e. occurring at the highest level of government or political establishment) or 'Petty' (i.e. occurring at administrative level for granting small favours). Both forms can co-exist and one can actually facilitate the other.
- (c) **Isolated and systemic corruption:** Corruption is systemic (pervasive or entrenched) where bribery is routine in dealings between the public sector and firms or individuals. Corruption is rare when it consists of a few individual/sporadic acts.
- (d) **Corruption in the private sector:** Private organizations can be a key source of providing bribes through unaccounted money generated by fraud. Where corruption is systemic in the public sector or 'grand' corruption, firms and individuals that do business with government agencies can seldom escape participating in bribery.

Impact of Corruption

The corruption impacts society and the whole economy in several ways, as pointed below:

Nathaniel Leff (1964) and Huntington (1968) have argued for "development through corruption." The arguments given by these economists are:

- (a) "Speed money" or bribes help circumvent bureaucratic red tape and speed up economic activity; and
- (b) It makes the government employees who receive bribes more efficient especially if the bribes act as a piece rate incentive.¹⁷

Leff's conclusion was based on the instance of freezing of food prices in Chile and Brazil in the 1950s. In Brazil, the regulation was circumvented by a corrupt bureaucracy, leading to increase in food production. In Chile, they were strictly enforced leading to lower food production. However, many economic research conducted subsequently on these perspectives does not have conclusive evidence in support of these points of view.

Also, while widespread corruption may coexist with strong economic performance, however, studies suggest that corruption is bad for development. In their study, Tanzi and Davoodi (1997)¹⁸ have concluded that corruption distorts the entire decision-making process connected with public investment projects. The evidence presented shows that higher corruption is associated with:

- higher public investment;
- lower government revenues;
- lower actual expenditure on operations and maintenance; and
- lower quality of public infrastructure.

Evidence also shows that corruption increases public investment while reducing its productivity as well



17 Corruption and Growth by Paolo Mauro, 1995.
<http://www.jstor.org/discover/10.2307/2946696?uid=3738256&uid=2129&uid=2&uid=70&uid=4&sid=21101255409687>

18 Corruption, Investment and Growth, by Vito Tanzi & Hamid R. Davoodi.
<http://www.imf.org/external/pubs/cat/longres.cfm?sk=2353.0>

as reducing optimal capacity utilization of existing investments. Lambsdorff (2003)¹⁹ has proven that there is a significant negative impact of corruption on a country's capital productivity. Most of the bribes and un-accounted money are utilized for private gains outside the formal economic system, thereby wasting precious resources and entrepreneurial talent that would have been otherwise allocated for the common good.²⁰ Paulo Mauro (1995) concludes that corruption lowers investment and economic growth. One standard deviation improvement in corruption indices causes investment to rise by 5 per cent of GDP and the annual per capita GDP growth rate to rise by half a percentage point.²¹

In their study on corruption, income inequality and poverty, researchers Gupta, Davoodi and Alonso-Terme (1998)²² have found that an increase of 0.78% in the rate of corruption will result in reducing the rate of income growth of the poor by 7.8%! In the same study they have also found that worsening of the corruption index by one standard deviation point will reduce the average secondary schooling of the poor by 2.3 years.

Corruption also leads governments to intervene where they don't need to because there may be a perverse agenda to extract rents by doing so i.e. permits and quotas, acquisition of private land for industry, etc. It is easily observable in many countries, including India that corruption tends to flourish when institutions are weak and government policies generate economic rents. In fact, Toke Aidt (2009) argues that corruption and inefficient regulation go hand in hand.²³ Artificial scarcity is first created through inefficient regulation to make room for

rent-seeking behaviour. Corruption is thus not independent but the product of the steps apparently taken to control it.

Further, due to limited resources and administrative bandwidth it undermines their ability to enact and implement policies in areas in which government intervention is clearly needed, i.e. education, health care, food security, etc. Therefore, apart from the economic cost, there is a social cost of corruption in the form of lower 'actual' investment in social and human capital.

Kauffman and Wie (1999)²⁴ have found that firms that pay bribes spend more time dealing with government officials. Bribes take a huge amount of time to be negotiated increasing inefficiency and cost. More studies, therefore, actually show that corruption decreases inefficiency unlike, what Leff and others like him have argued.

In a recent estimate by the World Economic Forum, the cost of corruption equals more than 5% of the global GDP or US\$ 2.6 trillion.²⁵ This is a huge amount and could have made a significant impact on the human condition if available for productive use.

While studies have shown that corruption reduces efficiency and increases inequality, quantifying the impact of corruption remains a challenge due to its very nature.

In a holistic assessment of the impact of corruption in the context of a developing country, Kofi Annan in a UNCAC document observes that:

*"corruption hurts the poor disproportionately by diverting funds intended for development, undermining a Government's ability to provide basic services, feeding inequality and injustice and discouraging foreign aid and investment. Corruption is a key element in economic underperformance and a major obstacle to poverty alleviation and development."*²⁶

19 How Corruption affects productivity by Lambsdorff J. G. <http://onlinelibrary.wiley.com/doi/10.1046/j.0023-5962.2003.00233.x/abstract>

20 Who pays for corruption? by Kaushik Dutta, Sameer Kapoor & Sumati Rajput. Article published in The Pioneer on September 14, 2012. <http://www.dailypioneer.com/business/94564-who-pays-for-corruption.html>

21 Corruption and Growth by Paolo Mauro, 1995. <http://www.jstor.org/discover/10.2307/2946696?uid=3738256&uid=2129&uid=2&uid=70&uid=4&sid=21101255409687>

22 Does Corruption effect Income Inequality & Poverty by Gupta, Davoodi and Alonso-Terme (1998). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=882360

23 Aidt, Toke S. (2009), Corruption, Institutions and Economic Development, Cambridge, University of Cambridge, working papers in economics 09-18.

24 Kaufmann, Daniel and Shang-Jin Wei (1999), Does "Grease Money" Speed Up the Wheels of Commerce?, Cambridge MA, NBER working paper 7093.

25 <http://reports.weforum.org/global-agenda-council-2012/councils/anti-corruption/>

26 The United Nations Convention against Corruption (UNCAC) December 2005.

CORRUPTION : DEFINITION, CAUSES AND EFFECTS

- Abuse of office/ position for private gain, encompassing diversion of legitimate funds.
- Business both cause and victim of corruption.
- Jeopardises interest of society, poor and vulnerable people leading to human rights violations.
- Undermines democracy, rule of law by promoting crime and terrorism.
- Various forms of corruption are : political and bureaucratic; grand and petty; isolated and systemic; and private sector corruption.
- Results due to opacity in rules, officers' discretionary powers, low deterrence in the form of punishments and consequences, low level of awareness or information asymmetry among general public.
- High Taxation, too many regulations & authorisations, subsidies and other spending decisions of the Government, Election funding, natural resource endowments also result in corruption.
- Corruption thrives in condition of low bureaucracy quality, public sector wages, institutional controls, transparency in rules, laws and processes and leadership examples.
- Corruption results in the lower economic development, Government revenue, public infrastructure inequality, income inequality, poverty, inefficient government regulation, reduced efficiency.

“Organizations lose 5% of their revenues to fraud each year with potential global fraud loss projected at more than \$3.5 trillion!”²⁷

Association of Certified Fraud Examiners,
2012 Report to the Nations.

AN INTRODUCTION TO FRAUD

Understanding Fraud: A Sub-set of Corruption

Fraud is a “*deception or misrepresentation that an individual or entity makes knowing that the misrepresentation could result in some unauthorized benefit to the individual or to the entity or some other part*” as per definition of the Association of Certified Fraud Examiners (ACFE).

In the real world it is very difficult to separate corruption and corporate fraud. They are intricately linked, as a corrupt environment makes it easier to perpetrate frauds; equally, frauds help generate illicit funds which can be used to win favours by paying bribes or for other quid-pro-quo.

In order to understand corporate fraud, it is important to better conceptualize various models that have been proposed on the subject. These models, based on research over a long period of time, can clarify various dimensions and facets of corporate fraud that need to be examined. It is however, important to note that ‘corporate fraud’ is a dynamic concept and there cannot be one over-arching model for fraud and conceptual models keep evolving.

Most literature on fraud uses a conceptual model called the fraud triangle, first suggested by Donald Cressey in 1950.²⁸ It hypothesises three conditions for fraud and says that generally all the three conditions should be present for a fraud to occur.



The Fraud Triangle

The conditions given by Cressey are as follows:

- (a) First, individuals committing the fraud possess an attitude that enables them to rationalize the fraud’;

- (b) Second, there is an incentive or pressure that provides a reason to commit fraud (e.g. pressure to achieve earnings guidance and linkage of the same to top management compensation);
- (c) Third, there is an opportunity for fraud to be perpetrated (e.g. absence of controls, ineffective controls, or the ability of management to override controls).

In 2004, Wolfe and Hermanson, introduced the “Fraud Diamond Model”²⁹ where they presented another side that extends the fraud triangle which is “the fraudster’s capabilities”.

They believed many frauds would not have occurred without the right person with the right capabilities implementing the details of the fraud. They also suggested four observable traits for committing fraud:

- (a) Authoritative position or function within the organization;
- (b) Capacity to understand and exploit accounting systems and internal control weaknesses;
- (c) Confidence that he/she will not be detected or if caught he/she will get out of it easily; and
- (d) Capability to deal with the stress created within an otherwise good person when he commits bad acts.

Another model called “MICE”³⁰ was propounded by Kranacher, et al. in 2010. In this model researchers suggested that incentive or pressure, which is one of the sides in the fraud triangle, may be more appropriately expanded and identified with the acronym MICE that stands for money, ideology, coercion, and ego representing the various motivations of fraud perpetrators.

All the above models may be regarded as an extension to Cressey’s fraud triangle and can be integrated into one model that includes motivation, opportunity, integrity, and fraudsters’ capabilities as its four dimensions.³¹

27 <http://www.acfe.com/rtn-highlights.aspx>

28 Cressey, D. R. (1950). “The criminal violation of financial trust”. American Sociological Review, 15 (6), pp.738-743, December, pp.1-15. Available at : www.JSTOR.org

29 Wolfe, D. T. and Hermanson, D. R. (2004). “The fraud diamond: Considering the four elements of fraud”. The CPA Journal, December, pp.1-5

30 Kranacher, M.-J., R. Riley, and J. T. Wells. 2011. Forensic accounting and fraud examination. Hoboken, N.J.: John Wiley.

31 Kassem, R. and Higson, A. 2012. The new fraud triangle model.

International Perspectives on Fraud

The Global Fraud Report³² 2012/13 by Kroll, which is based on a survey of 839 senior executives worldwide, notes that “India, despite some improvements, remains a challenging fraud environment. Outside Africa it possesses the highest number of companies affected by fraud in any region or country (68%) and its average loss to fraud (1.2% of revenue) is significantly higher than the global average (0.9%).”

The Global Fraud Report (2012/13),³³ further notes that while the number of firms affected by corruption in India dropped to 31% in a 2012/13 survey as compared to a 2011/12 survey, the percentage is still higher than the global average of 11%. It also mentions that corruption remains a leading concern for Indian companies with as many as 50% reporting themselves to be moderately or highly vulnerable to it.

It also states that some types of fraud were more widespread in India as compared to the global average. In particular, it mentions internal financial fraud (22% as compared to 12% globally) and vendor or procurement fraud (20% as compared to 12%) more prominent in the country than its global counterparts.

The Association of Certified Fraud Examiners' (ACFE), “*Report to the Nations on Occupational Fraud and Abuse 2012*”³⁴, compiled from a study of 1,388 cases of fraud that occurred in 94 nations (including 34 cases from India) between January 2010 and December 2011 based on the information provided by investigating Certified Fraud Examiners.

Some of the main findings of the report are:

- Asset misappropriation accounted for 88.7% of reported incidents.
- Corruption, which includes conflicts of interest, bribery and extortion, accounts 27.4 % incidents.
- Manipulation of financial statements accounted for 10.3% of reported incidents.
- Frauds took an average of 18 months before being detected and are more likely to be detected by a tip-off (usually by employees) than by any other method.
- Fraud is a significant threat to small businesses which suffered the largest median losses because of the few anti-fraud controls than their larger counterparts.
- 50% of the organizations are not able to recover the losses that they suffer due to fraud.
- In 81% of the cases, the fraudster displayed one or more behavioural red flags that are often associated with fraudulent conduct.
- Living beyond means (36% of cases), financial difficulties (27%), unusually close association with vendors or customers (19%) and excessive control issues (18%) were the most commonly observed behavioural warning signs.
- The most common industries impacted are government and public administration, banking and financial services and manufacturing sectors.

32 Global Fraud Report 2012/13 by Kroll Advisory Solutions. Page 40

33 Global Fraud Report 2012/13 by Kroll Advisory Solutions. Page 40

34 http://www.acfe.com/uploadedFiles/ACFE_Website/Content/rtn/2012-report-to-nations.pdf

Public Procurement and Fraud

The procurement function is especially prone to corruption and kickbacks. In the procurement function, employees are expected to select vendors, raise purchase orders, maintain vendor files and approve final invoices. Having such responsibility and authority provides an opportunity to commit frauds such as favouring vendors where they have a direct or indirect financial interest, bid rigging, false billing, kickbacks (bribes) from vendors, etc.

The Global Fraud Report³⁵ 2012/13 states that while the incidence of procurement related fraud fell globally from 20% to 12%, in India the incidence changed marginally from 22% to 20%, showing that India was not really making significant progress in this area.

In their India fraud Survey 2010,³⁶ KPMG finds that most respondents identified the procurement process to be more vulnerable to fraud risk. Notably 57% of the respondents from real estate and government industry segments put procurement at high risk, well ahead of other function like finance and payments as well as treasury which have been traditionally considered to be highly vulnerable to fraud risk.

A thought paper by international consulting firm Deloitte, titled 'Procurement Fraud & Corruption: A multifaceted challenge'³⁷ brings out why the whole procurement cycle is very susceptible to fraud. At the pre-procurement stage itself there could be collusion between the buyer and the vendor, conflicts of interest, poorly written specifications or vague/customised specifications to favour a particular vendor, etc. At the procurement assessment & negotiation stage there could be bid rigging schemes, defective pricing schemes and bid submission schemes which favour a particular vendor. Further, at the contract performance stage there could be product substitution, false invoices, phantom vendors, mischarges and missing inventory or lack of proper supporting documents, etc. Finally at the contract closeout stage there could be

missing contracts and document destruction. The paper also provides the possible 'red-flags' that may indicate procurement fraud and ways to prevent, detect and investigate such a fraud.

In their 'Green Paper on Procurement in India', the Global Compact Network (GCN), India has raised several issues related to public procurement, which are mentioned below:

- Procurement officials express confusion created by the existence of multiple procurement guidelines and procedures issued by multiple agencies;
- Lack of standardization and proper documentation causes inefficiency and is a major hurdle in ensuring transparency, probity and accountability in procurement;
- Public procurement is governed by administrative rules and procedures which only attract departmental action in case of violation;
- Absence of penal consequences for misrepresentation, cheating or fraud in public procurement, except under normal penal code for dealing with complex procurement matters.

A serious problem confronted by public procurement is the malpractice of cartel formation accompanied by collusive bidding and bid rigging. An anomaly observed is that there is an attempt to apply the procurement procedures and guidelines in letter without an appreciation of the spirit behind these stipulations. Further, lack of specialized knowledge and skills of personnel operating the procurement system does not make the system much efficient. Due to these anomalies, a consensus is emerging in favour of enacting a public procurement law in India with the objective of maximizing economy and efficiency and promoting competition among suppliers and contractors.

The National Academy of Defence Financial Management has also created a draft discussion paper titled 'Public Procurement: problems and prospects',³⁸ which observe that: "*procurements by Governments have always been controversial with allegations of favouritism, inefficiency, quantitative and qualitative compromises and above all, corruption and kickbacks.*"

35 Global Fraud Report 2012/13 by Kroll Advisory Solutions. Page 41

36 http://www.kpmg.com/IN/en/IssuesAndInsights/ArticlesPublications/Documents/KPMG_Fraud_Survey_2010.pdf

37 <http://www.deloitte.com/assets/Dcom-India/Local%20Assets/Documents/Thoughtware/Procurement%20Fraud%20Corruption%20Brochure.pdf>

38 <http://nadfm.nic.in/learning/Research%20Cell/Public%20Procurement%20-%20problems%20and%20prospects.pdf>

Impact of Fraud on the Valuation of a Company

In a recent study by Dyck, Alexander, Morse, Adair and Zingales, How Pervasive is a Corporate Fraud? (February 22, 2013) attempted to estimate as to what percentage of firms in the USA engage in fraud and the economic cost of such fraud.

The researchers find that the probability of a company engaging in a fraud in any given year is 14.5% based on the data of detected frauds, and frauds that are started but are not caught. They validate it using alternative methods. They find that “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 authors arrived at this loss in corporations’ value through extrapolations “from the pre-fraud period, assuming the trajectory would have followed that of other firms in the same industry.” They find a median loss of 20.4 percent in fraud companies valuations, by benchmarking them against their valuation before the start of fraud.

In a similar study on an approach to measure the cost of fraud by Karpoff, Lee and Martin (2008) that is well suited to situations with financial frauds, estimates that the social costs of fraud of 21.8% of enterprise value.

The key take away from these studies is that the risk of fraud is pervasive across all enterprises and countries irrespective of their sizes and the economic and social costs are not localised to the entity committing fraud but is also borne by the entire population of firms in that sector or geography as the investors put a higher risk premium across all enterprises.

There are no specific studies done in India for determining the pervasiveness of misreporting of financial statements and the effect on the valuation of the enterprise on the discovery of such fraud. However, if such a study was done in India, one might think that the results would not be very dissimilar in relation to the pervasiveness of fraud and financial misstatements.

For the purpose of this report, we are restricting our research and study to corruption and fraud in the private sector in a focussed manner. Fraud and corruption often happen in unison. It is therefore important to understand them and to explore bribery/corrupt transactions from the perspective of the giver.

FRAUD: DEFINITION, PERSPECTIVE AND IMPACT

- Fraud is a wilful act of deception or misrepresentation resulting in an unauthorized benefit to the perpetrator or others.
- Fraud is intricately linked with corrupt environment.
- Vital conditions for occurrence of fraud are pressure, rationalization, opportunity, capabilities and integrity of perpetrators.
- Internal financial fraud and vendor or procurement fraud are more prominent in India.
- Major reasons for fraud in public procurement – favouritism of a particular vendor with direct or indirect financial interest, bid rigging, false billing, and kickbacks from vendor.
- The social cost of fraud is 21.8% of enterprise value.

CORRUPTION AND FRAUD IN CORPORATE INDIA

Corruption in Corporate India - A Perspective from Independence to Modern Times

A business cannot operate in a vacuum and depends on the eco-system created by the interplay of government and society for its inception and growth.

Historically, the operating structure of most Indian business was based on the family set-up and values. The capital was provided by the family, it was run by family members taking up important functions in the business and the economic returns were also shared with the family. Under the British rule, the concept of a company did come into play but while corporations were formed in the form, the essence of the enterprise remained the family. R. K. Hazari, a noted historian, has estimated that most prominent industrial firms on the contours of Indian business during the 1950s were in the hands of just eighteen Indian families and two British houses.³⁹

Dr. William Gould mentioned in his article that at the time of independence in India:

“The system of food and civil supply was subject to commodity controls and rationing – a legacy of the war years which had generated complex systems of patronage. These involved deeply entrenched black markets in lucrative industrial and agricultural concerns. This was the background to what was later known as ‘Permit-Licence-Quota Raj’ – the linking of business interests with political brokers.”⁴⁰

³⁹ 'India Means Business': How the Elephant Earned its Stripes, Kshama V Kaushik, and Kaushik Dutta, Oxford, 2012, page 54.

⁴⁰ A brief history of corruption in India by Dr. William Gould. <http://www.theindiasite.com/a-brief-history-of-corruption-in-india/>

Indian businesses, traditionally family-owned, needed licenses from the Government to run their businesses. The success of such businesses depended to a great extent on their ability to receive a license or a right to receive rent from an allocation of assets or right from the government. There is a deep-rooted nexus between bureaucracy/politics and business in India. It is getting deeper as politics has now become dynastical; the need to stay in power is not restricted to a generation but moves to the future ones, which fuels the constant need for money to sustain the power equation including fighting elections.

The government encouraged a mixed economy, i.e. both private sector and state controlled public sector to invest in the economy, to boost economic growth. However Indian policy makers were also hugely influenced by socialist paradigm and the use of the public sector for greater social good. So over a period of time, the state decided to curb the growth and economic wealth concentrated with the private sector.

In independent India corruption has been rampant, though a number of laws have been legislated to curb corruption and fraud. One of the reasons for high levels of institutional corruption in India is due to the deep entrenchment of businesses and now politicians, who are becoming dynastical, in their restrictive domains. However, there is now a growing trend of fungibility between business and politics where there is a thin dividing line and people move over from one to the other with consummate ease.

For four decades starting from 1950, the growth of business groups was regulated by a few principal legislative instruments which were restrictive in nature. Some of these acts, which stand withdrawn or superseded today but were the tools of control for government, include the Industrial Development and Regulation Act, 1951 (the primary law on licensing which restricted the number of manufacturers for a specific product), the Monopolies and Restrictive Trade Practices Act (MRTP), 1969 (a law restricting market growth and market size share), and the Capital Issues (Control) Act, 1947 (a law on how an equity should be priced based on net assets or past profits as against market driven valuations on future prospects).

There were sections in the Companies Act, the law that governs corporate India, which contained restrictions on growth by limiting inter-corporate deposits, inter-company investments, directorships, etc. These pieces of draconian legislations in effect created what was known as the 'license-permit raj', allowing near-absolute government control over private enterprise activity in the country.⁴¹ All these developments provided huge opportunities for these businesses that were quick to grasp them by means both fair and unfair.

Such laws which were meant to regulate private enterprise became so overbearing that entrepreneurship became an exercise in survival. To survive and in fact to grow, private business often resorted to corrupt practices including bribery to ensure that they got the license, permits and quotas while their competitors were denied the same. Thus regulations which were put in place with intent to curb malpractices only enhanced them in reality and made it an established way of doing business.

The other element of concern is that a number of people with a criminal past representing national parties join politics and win elections. This sends out a message to people that there are no legal consequences for criminal activities, thereby severely compromising the rule of law. This disregard for laws permeates to other parts of society and puts it at risk.

The advent of the 1970s saw even tougher regulations being introduced. In 1970, the marginal rate of income tax in India, including surcharge was a whopping 93.5 per cent and additionally there was a tax of 8 per cent on one's wealth. These high tax rates till the reforms in the 1990s gave very little incentive for business to expand and create wealth.

Corruption and evasion of taxes was rampant and 'black money', money on which tax was evaded was nearly as big as the real economy.⁴²

The high tax rates coupled with high level of controls ensured flight of private capital from the country and some business families decided to set up business ventures outside India to escape the iron hand of the government in India. While, rumours of vast amounts of money being deposited in tax havens by rich Indians has never been conclusively proven, high income tax and wealth tax rates have definitely been responsible for giving a fillip to the 'black economy'.

The Foreign Exchange Regulation Act (FERA) of 1974 made it mandatory for foreign companies with a stake over a certain threshold to seek government permission or sell the excess shareholding through public listing. In the absence of current account convertibility, every small foreign exchange transaction needed the approval of Reserve Bank of India (RBI). Due to changes in laws in 1977, about sixty companies including Coke and IBM, left India rather than share their proprietary technology with others.⁴³

Till the 1990s, raising finances to run large businesses was a key challenge for the private sector, particularly after nationalisation of banks in the 1970s had ensured that business houses did not have an internal bank to fund group activities. Additionally, Indian promoters in this era preferred using public money either from government-owned banks or financial institutions like IFCI (Industrial Finance Corporation of India), IDBI (Industrial Development Bank of India), LIC (Life Insurance Corporation), and ICICI (Industrial Credit and Investment Corporation of India), several state financial institutions, besides UTI (Unit Trust of India), or less frequently from the public, to run the enterprise they controlled. These institutions were the providers of long-term credit in exchange for seats on the boards of the borrowing companies, in effect investing taxpayers' money in the private sector with apparent government oversight.⁴⁴

Economic liberalization which started in 1991 due to the dire financial condition of government finances turned out to be a blessing in disguise for the common citizens and corporate India. It would not be wrong to say that

41 'India Means Business': How the Elephant Earned its Stripes, Kshama V Kaushik, and Kaushik Dutta, Oxford, 2012, page 56.

42 'India Means Business': How the Elephant Earned its Stripes, Kshama V Kaushik, and Kaushik Dutta, Oxford, 2012, page 57.

43 'India Means Business': How the Elephant Earned its Stripes, Kshama V Kaushik, and Kaushik Dutta, Oxford, 2012, page 57.

44 'India Means Business': How the Elephant Earned its Stripes, Kshama V Kaushik, and Kaushik Dutta, Oxford, 2012, page 57.

the dismantling of some of the draconian laws and the resulting control was akin to the 'economic freedom' for the citizens of India almost similar to the 'political freedom' achieved in 1947. This has also led to the creation of a large and assertive educated middle class, which was marginal and submissive pre-1990s.

The growth of large business groups in the 1990s and beyond was in part due to the easing of controls over sector-related policies, a more benign tax and duty regime, and de-reservation of sectors to permit private sector participation (such as petroleum refining or oil exploration, telecommunication and defence).⁴⁵

45 'India Means Business': How the Elephant Earned its Stripes,

CORRUPTION AND FRAUD IN INDIA

- Corruption rampant in India due to deep-rooted nexus between bureaucracy/ politics and business in India, a dynastical form of political parties fuelling the need for money to sustain the power equation including fighting elections.
- Promulgation of certain Acts, such as Industrial Development and Regulation Act and MRTP Act prompted private business to resort to corrupt practices including bribery to ensure that they got the license, permits and quotas while their competitors were denied the same.
- The high tax rates coupled with high level of controls resulted in flight of private capital from the country and encouraged parallel or black economy.
- Raising finance to run large businesses was a key challenge for the private sector, particularly after nationalization of banks in the 1970s.
- Economic liberalization in 1991 endowed opportunity for private sector growth.

RESEARCH DATA AND ANALYSIS

Methodology, Rigour and Limitations

This section discusses our research methodology and data analyses for analysis of fraud by management in private sector companies in India.

The risk of fraud is an inherent risk in all financial statements issued by companies all over the world. India is no exception and in recent years there have been some fairly large frauds that have jolted the Indian corporate sector, government and society as a whole.

In this section we conduct an in depth analysis of the major corporate frauds that happened over the last 15 years so as to understand the underlying factors, modus operandi and outcomes of these frauds.

Financial Statement Fraud: Background

The three main government agencies involved in the investigation and prosecution of companies involved in large scale corporate accounting frauds are the Serious Fraud Investigation Office (SFIO), the Central Bureau of Investigation (CBI) and the Income Tax (IT) department. We have considered data from all the cases investigated by the SFIO and some of the cases investigated by the CBI and the Income Tax department based on what is available in the public domain. In short, our sample for the purpose of this report, covers cases that have been investigated by one or more of these three agencies.

The **Serious Fraud Investigation Office (SFIO)**⁴⁶ was set up by the Government of India under the Ministry of Corporate Affairs (MCA) in 2003 and is a multi-disciplinary investigating agency, wherein experts in the banking sector, capital markets, company law, other laws, forensic audit, taxation, information technology etc. work together to analyze and investigate a corporate fraud.

The SFIO is the primary agency for investigating corporate frauds and takes up investigation of frauds characterized by:

- (a) Complexity, and having interdepartmental and multi-disciplinary ramifications;
- (b) Substantial involvement of public interest in terms of monetary misappropriation (Rs.50 crores or more, or where the paid up capital of the company is Rs.5 cores or more of which at least 20% has been subscribed by the public);
- (c) Substantial involvement of public interest in terms of persons affected (at least 5000 persons);
- (d) The possibility of investigations leading to, or contributing towards a clear improvement in systems, laws or procedures.

The annual report of the MCA, for 2011-12 has this to state about investigation of corporate frauds "*Government of India, through its multi-disciplinary investigating agency, namely, the Serious Fraud Investigation Office (SFIO), carries out an investigation under the provisions of the Companies Act, 1956. During 2011-12 (upto 31.12.2011) seven fresh cases have been ordered for investigation. So far, a total of 89 cases have been referred to SFIO for investigation. Out of these, SFIO has submitted investigation reports in 73 cases, four cases have been either stayed or dismissed by Courts and the remaining 12 cases are under investigation.*"⁴⁷

The **Central Bureau of Investigation (CBI)**⁴⁸ is part of the Department of Personnel, Ministry of Personnel, Pension & Public Grievances, Government of India. It is the premier investigating police agency in India which also coordinates investigations on behalf of Interpol Member countries. The services of its investigating officers are sought for all major investigations in the country. It is also involved in collection of criminal intelligence pertaining to three of its main areas of operation, viz., anti-corruption, economic crimes and special crimes. Special crimes include crimes involving terrorism, bomb blasts, high profile homicides, kidnappings and the underworld. Thus it handles a large number of very complex cases.

Kshama V Kaushik, and Kaushik Dutta, Oxford, 2012, page 61.

46 Annual Report 2011-12, Government of India, Ministry of Corporate Affairs. Page 16

47 Annual Report 2011-12, Government of India, Ministry of Corporate Affairs. Page 5

48 <http://cbi.nic.in/aboutus/cbiroles.php>

The **Income Tax department**⁴⁹ has been formed under the Department of Revenue, Ministry of Finance, Government of India, for the purposes of administration of direct tax laws. It works under the supervision and control of Central Board of Direct taxes (CBDT). The CBDT provides essential inputs for policy and planning of direct taxes in India and is responsible for administration. The investigation wing of the Income Tax Department deals with investigations to detect tax evasion and carries out operations like surveys & searches to collect evidence of such evasion and seizure operations to unearth black money. Such operations are usually carried out after detailed preliminary investigations.

Besides these three agencies there is also the Directorate General of Economic Enforcement or the **Enforcement Directorate (ED)**,⁵⁰ which is also an agency responsible for economic intelligence and law enforcement. It is part of the Department of Revenue, Ministry of Finance. It covers cases related to money laundering and related economic crimes. It was established in 1956 and has been functioning in its current form since June, 2000 to investigate provisions of the Foreign Exchange Management Act, 1999 (FEMA). However, we are not analyzing such cases as they may not have a corporate accounting fraud angle and the ones that do have corporate fraud are subsequently investigated by either the CBI or the SFIO or both and so would automatically be covered under those agencies.

Further, under the Constitution of India, the police and public order are stated (provincial) subjects. Every State/ Union Territory has its own police force, which performs not only normal policing duties but also has specialized units to combat economic offenses. The Economic Offences Wing (EOW) of the Police functioning under the administrative control of states (provinces) is entrusted with the responsibility of investigation of serious economic offences and offences with inter-state ramifications. It is also mandated to interact, assist, and guide the district police on matters related to financial crimes and preventive and detection measures.⁵¹ Cases investigated by state

police agencies are usually small in magnitude and not complex, hence we have not considered this data for this report as the large number of small cases tend to skew the data and do not allow for a meaningful analysis.

Our Methodology

The final sample of over 100 companies included in this study covers a period of 15 years from April 1997 to March 2012. In the event that an investigation has been conducted by multiple agencies, we considered all the available information from each such agency.

Information has been obtained from charge sheets, court orders, filings with stock exchanges, specific databases supplemented by web searches, searches of newspapers and journals, Lok Sabha questions and answers etc.

Both qualitative information and quantitative data have been considered at the data collection stage to obtain a holistic understanding of the underlying information. The overall objective of the analysis was to gain an insight into the nature of fraud, type of companies involved, the trends in corporate fraud, the underlying characteristics and techniques used, factors motivating the fraudsters etc. and to present the data and our interpretations in a meaningful manner.

We have restricted our study to fraud perpetrated by management of companies and not those, where a company was a victim of fraud by employees, vendors or any other person.

49 <http://www.incometaxindia.gov.in/>

50 Black Money. White Paper 2012. Ministry of Finance. Department of Revenue. CBDT, New Delhi

51 Black Money. White Paper 2012. Ministry of Finance. Department of Revenue. CBDT, New Delhi

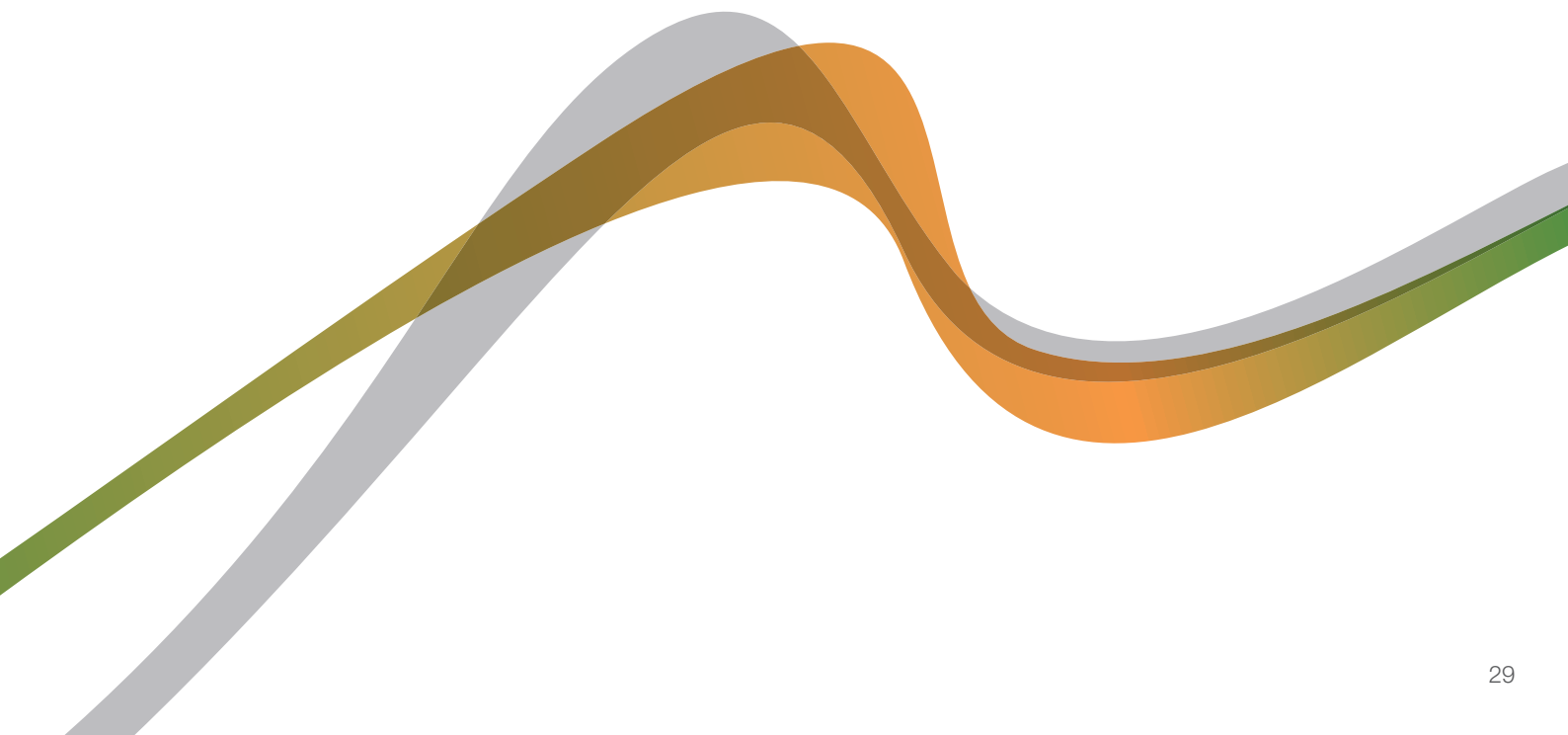
Limitations

The data for this study has been collected through various sources of secondary data. However, despite our best efforts, some cases may not have been considered due to inadequate information available in the public domain. The results of the study should therefore, be seen to be indicative and suggestive rather than being definitive.

We have not considered any variable in this study unless at least 85% of the data relevant for the population was available to analyze the variable. Where an exception has made to this rule, we have specifically mentioned it while analyzing that variable.

We limit our analysis to cases of fraud in private sector companies which have been perpetrated only by promoters and management commonly referred to as 'management fraud'.

The sample does not cover employee fraud, which also exists in the corporate sector.



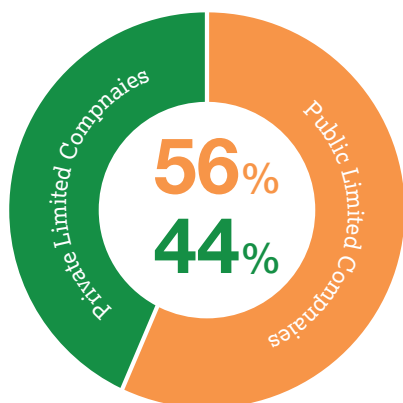
Results of our Data Analysis

Type of Ownership and Co-relation with Higher Risk of Fraud

We explored the nature of the shareholding of a company, in the endeavour to ascertain some relationship between the nature of ownership and propensity to de-fraud. In our study, public limited companies constituted 56% of the sample, and the rest were private limited companies. Hence, the prevalence of fraud appears to be evenly distributed among public and private limited companies. Further, 44% of the companies in the sample study, where fraud was detected were listed on Indian stock exchanges. In nearly two-third of these listed companies, promoters had a shareholding of over 50%.

Concentrated promoter shareholding may also lead to higher earnings management⁵² and has been statistically proven on Indian companies using Bernford's Law.⁵³ The dividing line between intentional earnings management and fraud is often very thin.

Distribution of companies on the basis of nature of company (%age)



52 Earnings Management' has been defined as purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain, Schipper, K., 1989. "Commentary on Earnings Management", *Accounting Horizons*, Vol. 3, pp.91-102

53 Exploring the Relation between Earnings Management and Corporate Governance Characteristics in the Indian Context, *Corporate Governance in India: From Policies to Reality*.

A study by Thought Arbitrage Research Institute and Grant Thornton titled "Taking Stock: Playing in the Indian Capital Markets"(2012)⁵⁴ shows that in case of listed companies with majority promoter shareholding, when the promoters of such companies pledge their shares for loans, the companies show higher share price volatility than the peer group and the rest of the market.

Fraud by owners and managers in India is independent of whether a company is privately held or publicly traded. Since there is usually a high promoter holding in publicly traded companies, their control over these companies is substantial and at times near absolute. Hence, the type of ownership has limited bearing on the risk of fraud by management and promoters, as they exercise significant control over both listed and private companies.

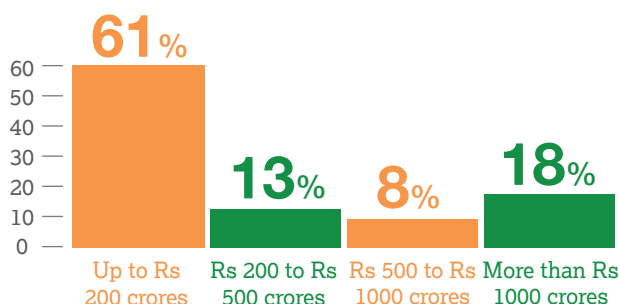
In India, a company whether privately owned or publicly traded is equally susceptible to fraud by management.

Size of a Company as an Indicator of Susceptibility to Fraud

We attempt to ascertain a relationship between relative sizes of companies based on their turnover and incidence of fraud.

Almost (61%) of the companies involved in fraud have small to medium scale of operations with revenue less than Rs. 200 crores. In our sample, 21% of companies had revenues of Rs. 200 crores to Rs 1,000 crores and 18% had more than Rs 1,000 crores.

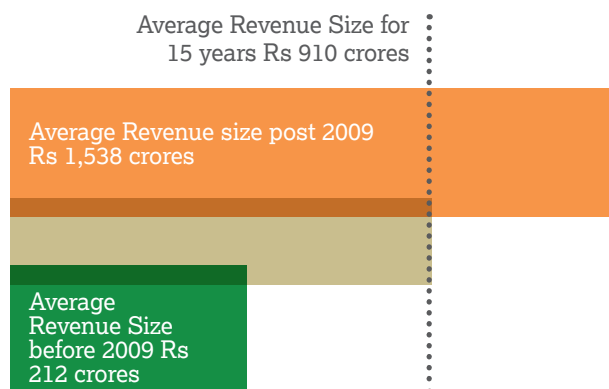
Distribution of companies on the basis of revenue size



54 <http://www.tari.co.in/index/reports/id/14>

Fraud is, therefore, present across various types of companies with turnover whether small, medium or large. The presence of a higher percentage of companies in the below Rs 200 crores category in our sample may be on account of the fact there are a larger number of smaller companies amongst the total number corporates in India.

It would be interesting to note here that the average revenue of the companies involved in fraud after 2009 was Rs. 1,538 crores, significantly higher than those involved in fraud before 2009.



The involvement of bigger companies in fraud over the last few years is a matter of concern as it exposes the interests of a larger number of stakeholders to risks of corporate failure.

Type of Industry and Incidence of Fraud

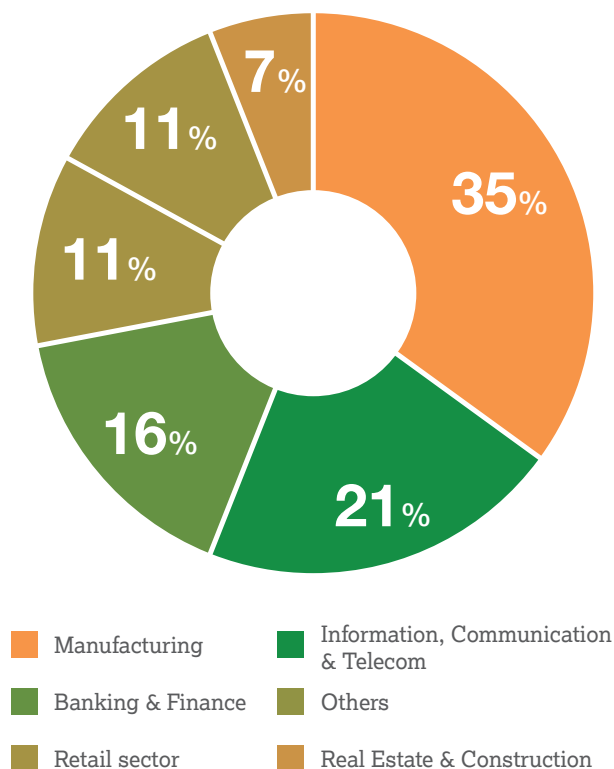
We evaluated whether any specific types of industries (manufacturing/ services/ banking etc.) were more prone to risks of management fraud.

The companies in the sample are fairly dispersed among the various sectors of industry, leading us to conclude that the incidence of management fraud is unrelated to the type of industry. All industries seem to be at a similar risk of management fraud though the services sector seems to be at a greater risk than the manufacturing sector.

Since over 57 % of Indian GDP is contributed by the services sector, one would expect to see in the future, services sector to have a higher proportion of delinquent companies than in the previous decades.

Hence any action to prevent, detect or deter fraud cannot be limited to any particular industry.

Distribution of companies on the basis of industry (%age)

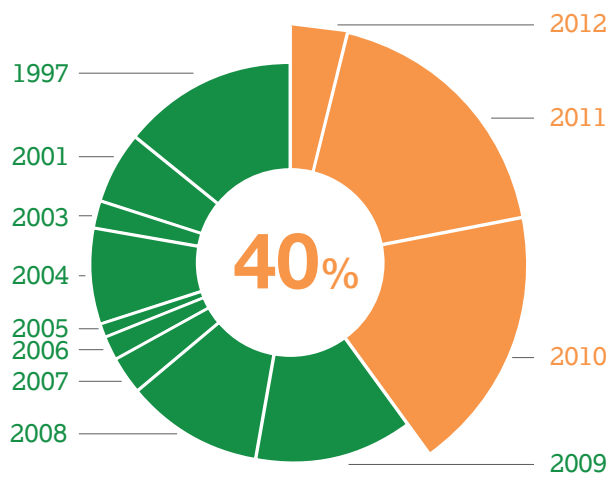


Number of Frauds Over the Years

60% of the reported cases in our sample pertain to the years 2009 and prior periods. However, 40% of the sample belongs to the three year period from 2010 to 2012. The sudden increase in detection of cases over the recent years may perhaps be on account of improved regulatory oversight from the MCA, RBI, SEBI etc. and increased oversight by other gatekeepers like auditors, lenders and investors etc.

The number of frauds detected since 2008 has increased significantly. This may be due to better oversight by regulators and gatekeepers.

Distribution of percentage of fraud per year



Size of Fraud Over the Years

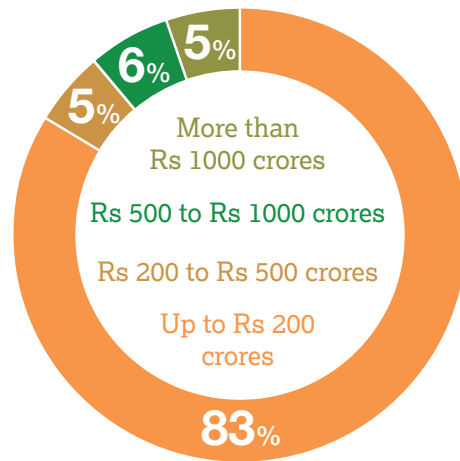
The size of frauds has been determined with regard to the amount of money misappropriated, embezzled or otherwise defrauded by management.

Amounts involved in the management's misstatements to stakeholders have also been taken into consideration. These include misstatements in financial statements and other public documents.

Information on the size of frauds was obtained from charge-sheets filed by the investigating authorities, court verdicts, government and other databases and information available in the public domain.

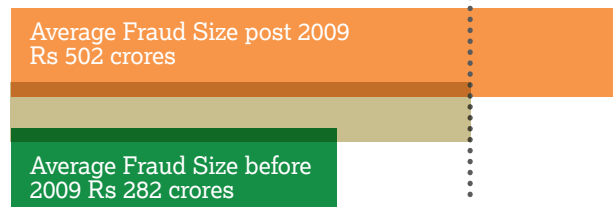
Our review reveals that 83% of the frauds are to the tune of amounts less than Rs. 200 crores, while 5% of them relate to amounts greater than Rs. 1,000 crores.

Distribution of companies on the basis of fraud size

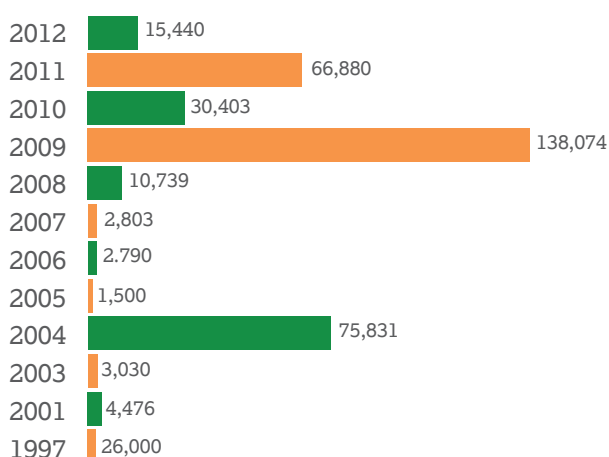


Prior to 2009, the average size of frauds was about Rs. 282 crores. This has significantly increased since then due to a number of high profile and large frauds detected in the period 2009 to 2012. The average size of frauds since 2009 is Rs 502 crores, an increase of almost 80% from the average of the past 15years.

Average Fraud Size for 15 years
Rs 381 crores



Total value of fraud (Rs crores) per year



As the size and number of companies involved in frauds has increased since 2009, so has the average size of frauds.

Management Motivation to Commit Fraud

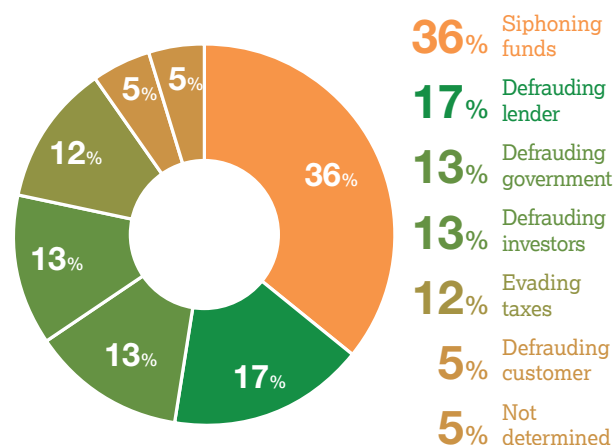
We analyzed data to understand the key motives of managers or promoters of companies to commit fraud. The underlying objectives of the fraud were examined in detail based on the pattern of fraud, charge-sheets and court judgements. We found that the main motives were:

- Siphoning of funds by promoters/top management (36%);
- Defrauding the lenders (17%)
- Defrauding the Government (13%)
- Defrauding investors (13%)
- Evading taxes (12%)
-

We found that a significant motivator for fraud by the promoters and management was a personal enrichment at the cost of all other stakeholders. However more research is warranted to understand the behavioural aspects of individuals committing such fraud.

The un-accounted money generated or the cash siphoned out could also have been used for bribes or for other investments of the family but currently we do not have sufficient data to conclusively support this hypothesis.

Distribution of companies on the basis of motivation for fraud



Techniques of Fraud

The underlying fraud schemes in the sample were studied to ascertain the modus operandi of the perpetrators.

In most cases multiple techniques were used to perpetrate the fraud. However, for our analysis purpose, we examined the most significant methods or procedures for committing such fraud. Where data was not available we have done this allocation based on our judgement and experience.

For example, there could be a revenue overstatement along with accounting for fictitious assets in the financial statements and false claims for expenses to cheat on taxes. In addition, there could be money taken out through related party accounts.

This analysis identified the following top five fraud techniques:

- Falsifying assets (32%)
- Related party transactions (23%)
- Inappropriate disclosures (13%)
- Recording fictitious revenue (9%)
- Overstatement of expenses (8%)

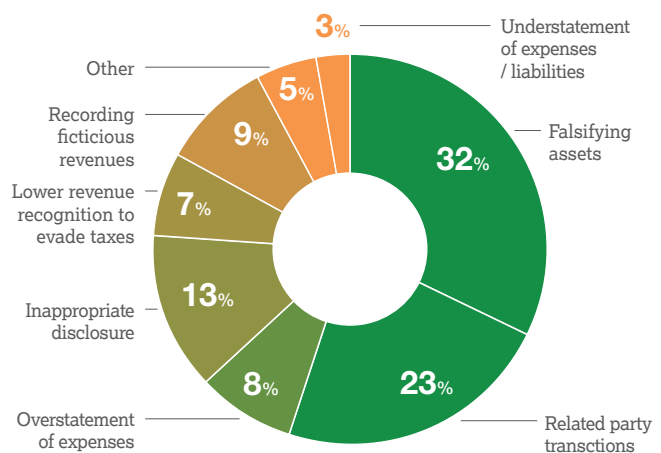
Falsifying assets refer to the technique of assigning values to assets reflected in the books of accounts that are significantly higher than their actual cost, so as to inflate costs. They may be existing or non-existent assets. This is a common technique used to inflate assets to give a false assurance to lenders that the cover is adequate, since lenders look at fixed asset coverage ratio while granting loans. In a few cases, falsifying assets also included understatement of asset values mainly for evading taxes.

In other cases funds may have been simply diverted to the personal accounts of promoters and top managers. Related party transactions comprise a web of transactions created among various group entities with fraudulent intentions. Recording of fictitious revenue is aimed at inflated the revenue of an entity. This typically happens in a listed company, where revenue is manipulated to meet earnings forecasts. Some other companies record fictitious revenues to meet the expectations of lenders or investors.

Overstatement of expenses mainly includes inflation of expenses either to reduce taxes or to siphon money through payments made to designated accounts for fictitious expenses or round tripped from suppliers.

Improper and misleading disclosures have also been made by some companies in the annual financial statements or other undertakings given to investors, banks & regulatory agencies such as SEBI, stock exchanges, RBI, Income Tax authorities etc. mostly to illegally receive capital/debt or to evade taxes.

Distribution of companies on the basis of fraud techniques



Fraud techniques used in the last 15 years have not undergone much change or sophistication with the most preferred fraud technique being overvaluation of assets. However we also observed that inappropriate disclosures and disregard to prudent revenue recognition norms has gained prominence in the cases detected after 2009.

Size of the Audit Firm and Risk of Management Fraud

Our study explored the correlation between the size of the audit firm and the occurrence of fraud to ascertain the effectiveness of auditors as gatekeepers. We obtained the names of audit firms from the audited financial statements closest to the time of detection of the fraud, available in the public domain. These audit firms were divided into two categories: Big 4 audit firms or their associates viz. Deloitte Haskins & Sells, Ernst & Young, KPMG and PricewaterhouseCoopers; and all other medium and small sized audit firms.

Audit firms used by companies in sample

Big 4 24%

Small and Medium Size Firm 76%

Our data showed that 24% of the companies in the sample were audited by Big 4 audit firms, and 76% of small and medium sized firms.

However, it would be interesting to note that unlike in the developed markets where large firms enjoy a significantly higher market share in India the audit concentration is not very high. An analysis of financial statements for the year ended 31st March 2011 of the companies forming part of the Bombay Stock Exchange 500 shows that companies are being audited both by Big 4 auditing firms (60% of the BSE 500) and non-Big 4 auditors (40% of BSE 500).⁵⁵

It would also not be out of place to mention that as one moves to smaller companies the share of big four auditing firms goes down further as Big 4 firms tend to audit larger and better known Indian companies.

We also looked at the relationship between the size of audit firms and the size of the fraud. We found that companies audited by the Big 4 audit firms accounted for 57% of the total fraud amount in the sample, suggesting that a Big 4 audit firm contributed to a significant **amount** of the fraud if not the number of fraud cases.

However, this study cannot find a co-relation between the occurrence of fraud and the presence of big 4 audit firm in such firms performing attest functions.

Fraud Detection

Our analysis of fraud companies in the sample, along investigation by agencies responsible for detection of management fraud in India suggests that key reasons are complaints by lenders/investors/customers which lead to the detection of the fraud detected by Income Tax authorities and detection and prosecution by other regulatory agencies (i.e. RBI, CBI, RoC, SEBI etc.).

However, no significant cases have come to light where the auditors have been able to detect such fraud in the course of their audits.

Earnings Management: Is it Pervasive Enough to be Fraudulent?

It may be important to mention that while our sample of 100 cases did not show a large number of frauds using sophisticated techniques, which may be due to the fact that more complex and sophisticated cases of corporate fraud have not come to light in India. However, the use of such techniques cannot be completely ruled out. As the Satyam scam showed, technology can be misused to maintain parallel books of accounts and perpetrate large scale fraud.

In a study on financial opacity for 33 countries conducted in 2002 by Bhattacharya Daouk, and Welker,⁵⁶ the researchers considered factors like:

- (a) Managerial motivation for lack of transparency (i.e. loss avoidance, aggressiveness in earnings and earnings smoothening);
- (b) Quality of accounting standards; and
- (c) Oversight and level of enforcement of accounting standards.

The authors found that India ranked at number 5 (i.e. the lowest transparency) along with countries like China, Japan, Greece, Indonesia and South Korea. US was ranked at no. 1 (i.e. highest transparency) while the UK was ranked no. 2.⁵⁷ This clearly indicates that the quality of Indian financial statements needs significant improvement to be considered best in class.

A recent study conducted together by Thought Arbitrage Research Institute and IIM, Calcutta for Indian Institute of Corporate Affairs of the Ministry of Corporate Affairs, India⁵⁸ shows that one can predict the presence of earnings management using the statistical formula called Benford's law (1938). In the study, the observed frequencies of the second digit were compared with the predicted frequency as given by Benford's law as each of the ten digits are not equally likely to occur in the second place. Most likely to occur are the zeroes and least likely are the nines, with other numbers falling in between.

55 Auditors: Judging by the Fairness of the Numbers, Corporate Governance in India from policies to reality, By Kshama V Kaushik, Kaushik Dutta, Rewa P Kamboj

56 The World Price of Earnings Opacity by Bhattacharya, U, Daouk, H and Welker, M (2002)

57 ibid

58 Corporate Governance in India. From Policies to Reality. By IICA, TARI & IIMC. Pg 148-187

The variables tested showed a positive profit after tax totalling for some 8026 firm over the years 2006-11. The study concluded based on the results of 8026 firm observations that there is the pervasive presence of earnings management in India.

The study also related corporate governance variables or proxy measures like presence of audit committees, size of company, ownership, auditors etc. to the practice of earnings mis-reporting and concluded that there were no definite co relation of the presence of such proxy measures and the quality of reported earnings.

Indication of 'earnings management' can play a key role in fraud prediction as it proves the presence of some pressure / motivation for the owner-managers to indulge in presenting incorrect numbers in financial statements. Further, its presence over a period of time also indicates a high level of tolerance or rationalization for 'managing the financial results'. Presence of earnings management can be construed to be a potential indicator of presence of financial statement fraud.

Effect of the Discovery of Fraud on Companies, its Promoters and Management

We tracked the companies post their indictment to understand how the fraud affected the company, its promoters and the management. We analyzed the impact on the companies' scale and continuity, valuations, closure etc.

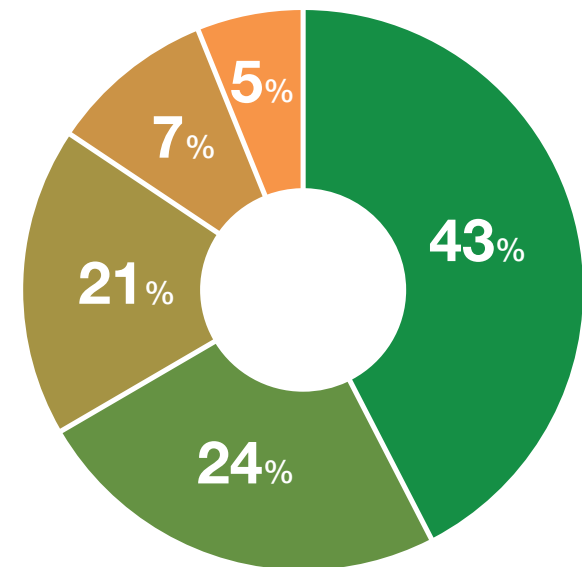
Our data analysis shows that, in 43% of the cases the business or the company ceased to exist. The companies have either been liquidated, are currently in the process of liquidation or their operations may have been discontinued. There are also some companies in the same category that are completely untraceable with no credible information available about their existence or operations.

In other instances, 30% of the cases the companies are continuing their business but at reduced levels. In some of the listed companies, market valuations have significantly fallen with little or no trading in their stock.

Further, in 5% of the cases there has been a change in management or the company has been merged with another entity. No determination can be made as to their current state of operations.

The scales of operations and market valuations have been marginally impacted due to the fraud in only 21% of the cases.

Distribution of companies on the basis of final outcome of fraud



- Company liquidated / under liquidation / business discontinued / non traceable
- Business continuing but the share price is significantly below face value
- Business continuing with marginal impact
- Business continuing at reduced levels
- Business continuing with change in management / merged

It would be appropriate to conclude that most of the companies where a serious accounting fraud took place have been severely impacted.

Thus frauds can have significant adverse consequences on the organisation's business operations and its continuity. However, information regarding the consequences for the promoters or top managers of these companies who were the perpetrators of the fraud is not sufficient. Hence as part of our study we could not conclude on this important aspect of the consequences.

Penalties and Criminal Prosecution: Are the Company Management Deterred by the Consequences?

We examined the amount of penalties levied and the criminal prosecution of people involved. Details of the cases filed against promoters/top-management and the final outcome of these cases is not available.

In a few cases where we could collect information regarding the indictment of the perpetrators of the fraud, we found delays in investigations because of the involvement of multiple agencies. Once investigations were completed, filing of charge sheets also took a long time. In such cases the prosecution of most of the accused have not been completed.

Due to the paucity of specific information in the public domain regarding serious corporate frauds, the study cannot comment authoritatively on the adequacy or otherwise of the penalties/fines imposed and recovered, the timelines within which the summons were issued and the court decrees/convictions obtained against the culprits.

The SFIO website mentions that they have 878 court cases pending against 49 companies where fraud was detected.⁵⁹ Out of these, 82 cases are under the Indian Penal Code (IPC) and 796 are under Company Law. They also have 9 cases against fraudulent companies in the Company Law Board⁶⁰.

The details of these cases are not available on the SFIO website. Regarding serious fraud cases, the 55th Annual Report on the working and administration of the Companies Act 1956 for year ended March 31st 2011 states that "During the year, in 39 cases the accused were convicted by the court and fines imposed."⁶¹ However, the report does not provide any further details regarding.

The 55th Annual Report⁶², however, gives the total fine imposed for violations, for the years 2006 to 2011, as well as the average fine imposed for each of these cases. The details are provided below:

Financial Year	Total fine Imposed (Rs.)	Avg. fine Imposed (Rs.)
2006-07	5,814.261	2,558
2007-08	1,11,84,020	2,618
2008-09	1,10,58,647	2,948
2009-10	92,30,317	2,484
2010-11	70,84,542	2,814

Prosecution and Convictions for Violations of Securities Laws

Our study analyzed violations of securities trading and related laws from 1998 to 2012, which have resulted in convictions and fines as a result of prosecution cases filed by SEBI. We have relied on the data in the SEBI website which was updated till September 30, 2012.⁶³ The objective of our analysis was to understand the effectiveness of the prosecution mechanism and whether it acts as a deterrence for the violators.

During this period, there were 139 prosecution cases including 540 people who were charged with criminal intent. The charges were for violations under the Companies Act, SEBI regulations and Collective Investment Scheme Regulations.

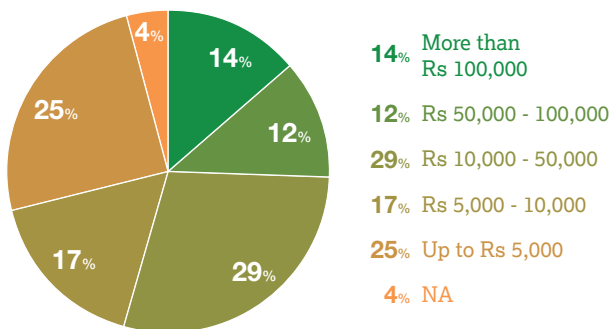
59 <http://www.s fio.nic.in/websitenew/in%20SFIO.pdf>
60 http://www.s fio.nic.in/websitenew/case_CLF.pdf

61 http://www.mca.gov.in/Ministry/pdf/55AR_English.pdf. Page 47
62 http://www.mca.gov.in/Ministry/pdf/55AR_English.pdf. Page 53.
63 http://www.sebi.gov.in/cms/sebi_data/attachdocs/1352177036821.pdf last accessed on February 7, 2012

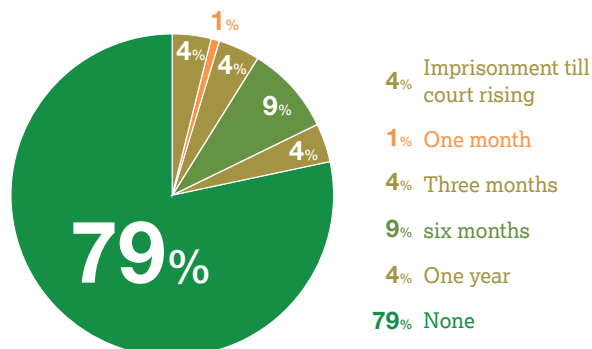
The results are as below:

1. The courts have imposed a total fine of Rs 374 lacs over these 133 cases (information not entirely available for 6 cases); in which 540 companies/ persons were convicted accused. This tantamount to a meagre average of Rs 69,311 per accused, with 46% of the accused levied a penalty of less than Rs 10,000 for being indicted in securities trading violations in India.
2. The analysis of average fines imposed over these cases, shows that in more than three fourth of the cases, average fine imposed is less than Rs 50,000.

Thus the monetary deterrence in case of default seems to be inadequate. However the study cannot comment on the actual collection of the penalty amounts.



3. We analyze the data from the results of prosecution to determine any criminal liability for violators by examining the court orders for sentencing as a result of the conclusion of the prosecution. The results displayed as under show that:



Thus our analysis can be summarized as:

- Nearly 80% of the criminal prosecution cases filed by SEBI do not result any sentencing.
- Further 18% of such cases resulted in a sentencing of less than 6 months.
- For every four people convicted by the court, there is at least one person is a proclaimed offender i.e. a person on whom the notices or the Court's order cannot be served as his whereabouts are unknown. Out of 540 accused convicted by the Courts, there were 133 proclaimed offenders in our sample size.

In case of the breach of SEBI laws or those which govern corporates, the consequent fines or length of sentences is not a deterrent or is punitive for defaulters. In fact given the paltry nature of fines or the facile length of sentences, it may even make it to be profitable for offenders to violate securities trading or corporate laws in India.

Does Implementation of Corporate governance through Norms like Clause 49 of the Listing Agreement help in Reducing Fraud?

The Securities Exchange Board of India (SEBI) mandated all public listed companies to comply with corporate governance norms specified under the Clause 49 of the Listing Agreement in its 2005 notification. In our sample, we examined those fraud cases that pertain to public limited listed companies and have been detected in or after 2005.

The annual reports of these companies in the year prior to the detection of fraud were studied to ascertain the composition of the board of directors and audit committees, the auditors' opinion in their report on the financial statements etc. The findings are stated below:

- In most of the companies, the board of directors had 50% to 75% independent directors, thereby raising questions about the effectiveness of independent directors in raising concerns in the event of any financial regularity.
- Auditors report was not qualified in most of the cases (80%), putting a question mark on the auditor's role in detection of fraud or as a gatekeeper of corporate governance.

- The Chief Financial Officer (CFO) and CEO had in all cases certified the accuracy of the financial statements and the adequacy of internal controls over financial reporting.
- The audit committees had more than three independent members in 70% of the cases and were still not able to detect these frauds.
- Directors have issued responsibility statements under the Companies Act giving their assurance on the quality of the financial systems, internal controls and the processes to detect fraud.

The above discussion augments the need for research on governance processes, interaction of governance characteristics and the efficacy of the corporate governance norms so far implemented in India.

Indicted companies complied with the prescribed norms of adhered to the norms prescribed in Clause 49 of the Listing Agreement only in letters and not in spirit. Thus, Corporate governance of Clause 49 of Listing Agreement by listed companies gives no assurance and often misleads on the quality of governance.

Conclusions: Dissecting Corporate Fraud in India

Simple Techniques: Most of the frauds covered in the sample in our study have deployed basic procedures or techniques suggesting the existence of internal control weaknesses that provides perpetrators 'opportunity' to engage in fraudulent activities and commit frauds.

As stated earlier most accounting frauds are carried out by promoters and/or top management for personal gain and enrichment. One of the key contributing factors for corporate fraud in India is the control and concentration of promoters, whether families or MNC's at the helm of affairs. Such controls over all aspects of business are often abused for personal gains at the cost of other stakeholders.

The techniques used also points towards abuse of power and discretion as well as wilful violation of laws. The existence of strong financial advisor (s) --confidants

who have the 'capability' to perpetuate a fraud--could be critical for fraud to be designed and committed. The existence of such people among the top management or promoters themselves could well be a high risk factor.

Tone at the Top: In fact the "tone at the top," of the promoters/top-managers set the moral and business philosophy of the enterprise, and when such a philosophy is misaligned with accepted ethical. It can create a huge amount of 'pressure' to manage results and falsify the books of accounts for short term gains. A tone that places a disproportionate emphasis on financial results or stock prices may send the message that cutting corners is not only acceptable but actually desirable.

These frauds are carried out with impunity as the chances of getting caught are minimal and the quantum of fine and punishment is not a valid deterrence.

Lack of Information/Enforcement: Further, the lack of adequate public information and/or punishment to the perpetrators of frauds indicates that there is inadequate enforcement of laws and deterrence for committing frauds. This also means that while there is a very high probability that the company and other shareholders might be severely impacted by the fraud, promoters and top managers are able to get away without any major punishment and more importantly they manage to retain the spoils of the fraud as personal wealth.

All these findings also reflect poorly on the watchdogs (i.e. internal, statutory and tax auditors) who take their cues from the gatekeepers i.e. regulators. The auditors should have been the first ones pointing out most of these frauds in the financial statements because the schemes do not seem to be too sophisticated or complex. They were however not able to play that role. It is also interesting to note that both the Big 4 and Non-Big 4 auditors have been providing various audits and other attest services to these companies, indicating that detection of fraud is hard even for large auditing firms.

RESEARCH DATA AND ANALYSIS

- The occurrence of fraud is almost equally poised between public and private limited companies.
- The companies involved in fraud have mostly medium scale of operations and average revenue size of less than Rs 200 crores. Further in 80% of the cases, the size of the fraud was less than Rs 200 crores. However the average revenue size of these companies has increased 7.25 times in the period after 2009, exposing the interests of larger number of stakeholders to risks of corporate failure.
- Fraud risk is pervasive across all the industry sectors with manufacturing sector involved in one out of three cases highlighting the need for appropriate fraud policies across all the sectors.
- There has been a recent spurt in not only in the number of fraud cases but also the size since 2009 with an average size of fraud almost doubling.
- Most of the fraudulent transactions were designed to either siphon of the companies funds by promoters or top management or to defraud government/ investors/ lenders.
- Fraud techniques used in last 15 years have not undergone much sophistication. Most perpetrators in our sample have recorded assets at a value which is higher than the fair value or alternatively have created a web of book entries through related party accounts to embezzle.

- There seems to be no plausible relationship between the incidence of fraud and the presence of big audit firms, though the companies audited by large firms have contributed more than half of the total size of fraud investigated by the Regulators.
- No significant cases have come to light where the auditors have been able to detect such fraud in the course of their audits.
- Presence of earnings management can be construed to be a potential indicator of presence of financial statement fraud.
- The majority of the companies involved in fraud have either been liquidated or business discontinued or is continuing at reduced levels with market valuations drastically reduced.
- The study cannot comment authoritatively on the adequacy or otherwise of the penalties/fines imposed.
- In case of the breach of SEBI laws or those which govern corporates, the consequent fines or length of sentences is not a deterrent or is punitive for defaulters.
- Effectiveness of clause 49 (corporate governance norms for public limited companies) covenants on fraud occurrence, detection and prevention is very limited.

STAKEHOLDER PERSPECTIVES ON PRIVATE SECTOR FRAUD IN INDIA

Four consultations were held with stakeholders in West, East, North and South India. The consultations were run by Global Compact Network India, and the International Business Leaders Forum, in partnership with Thought Arbitrage Institute, and a series of regional partners. The primary audience was business – private and state owned. Government stakeholders were also consulted, especially those in vigilance roles. Accounting bodies, industry associations and academia were also involved in these discussions.

After sharing the data, stakeholders were asked to:

- Provide feedback on the patterns and trends identified – do they feel right? Will they be useful?
- Share approaches to reducing the risk of fraud – particularly from an accounting/auditing perspective
- Highlight specific vulnerabilities they have come across, in their business or sector
- Flag at what junctures businesses can do a U-turn, how they can come out of complicated situations.
- Exchange good practices and practical nuances.

Dialogue between stakeholders was encouraged. The discussions were characterised by their responsibility, passion and frankness. Most of the recommendations for each stakeholder group came from within that group, but there were challenges across groups, and these recommendations have been captured too.

The consultations were held off the record, so though the participants are listed, none of the content recorded here is attributed.

Consultations were held as follows:

- Bhubaneswar, hosted by Xavier Institute of Management in Business, on October 13, 2012
- Mumbai, hosted by Bombay Chamber of Commerce and Industry, on October 23, 2012
- New Delhi, hosted by Oil and Natural Gas Corporation in partnership with the Federation of Indian Chambers of Commerce and Industry, on November 9, 2012
- Hyderabad, hosted by National Mineral Development Corporation on 19th November 2012

Perceptions On The Landscape

An Indian Problem?

A theme of the consultations was why India was suffering from corruption in general, more broadly than simply private sector fraud.

Some participants voiced anger over the impact of corruption on poverty in their states (Bhubaneswar). Others asked whether corruption was inherent in Indian religious or business practices (Hyderabad). This view was countered by those whose perspective was that the values held by individual Indians was not reflected in India's position on Transparency International's corruption perception index (Mumbai). Others argued that MNCs had made corruption a fine art in India, through the use of lobbyists (Delhi).

"We have accepted corruption to a large extent. We interact with people in our circles who have taken bribes".

Laws, technology, values

A series of gaps in the legal and governance framework were highlighted. For example, certain arms of government vigilance are unable to pursue companies for fraud or corruption -uncovered during investigations unless there was a criminal angle to it. The Indian financial regulators, which have been compared favourably with the performance of their Western counterparts, were encouraged to move from recommending certain measures for companies, to making them mandatory. For example, whistle blower protection mechanisms.

A strong message emerged about finding solutions that work in India. Technology was seen as bringing transparency, removing discretion, and enabling data mining, for increased fraud detection. At the same time, technology shouldn't be seen as a panacea.

"You can't create a new technology and wish away corruption. Systems are important, culture is too."

“We always ignore corruption in private sector. But there is large-scale fraud. We must aim to understand fraud in private sector. We always take an economic view of corruption. We should also look at the moral question. The whole purpose of this exercise is to make us think.”

Bhubaneswar Audience

And a strong focus on ethics emerged. Complementing the legal framework and prevention through technology, was the view that business ethics was a matter of business excellence, an area for strong personal leadership, and for cultivating responsible behaviours within organisations.

“Total Quality Management transformed business practice in India. We need Total Ethics Management.”

Common Ground

There has traditionally been a gap between business and government in discussions on fraud and corruption. These consultations were unusual in that they were well attended by vigilance practitioners from business and from government.

Participants challenged each other:

“My fear is that companies will be the victims of a witch-hunt by state investigating agencies”

“Adopting aggressive tax plans make companies vulnerable to extortion”

“Some in Government are at sea too – and don’t know how to fight corruption.”

“Increasing salaries to reduce corruption is like giving a bribe to stay clean”

However, by focusing on the challenges faced by both sectors, shared priorities and approaches were identified. There was recognition that government corruption and private sector fraud were two sides of the same coin, and that similar strategies could be used to mitigate risks in each sector.

“India is a value brand. Corruption and fraud directly impact this.”

Boards

Setting the right tone at the top was cited at all the consultations. Compliance and transparency should be seen as a matter of business excellence, with the leadership committed to it.

Code of Ethics

Business stakeholders emphasised that each company, irrespective of its size, should have a code of ethics which could serve as an internal check in detecting corruption.

Audits

Auditing was seen as a very powerful and helpful tool, if a culture can be created where people accept it. In addition to classic financial audits, boards were encouraged to commission both system audits and transparency audits.

A system audit done properly will help reduce corruption. It can help companies assess and revise policies and make recommendations for reform. This concept was extended further, through the notion of a transparency audit, auditing systems and behaviour.

Alongside this, board education was highlighted. Ensuring that all directors are sufficiently financially literate to provide proper oversight.

“Customers do due diligence on you, if they see any cloud, they won’t do business”

Human Resource Managers

Human Resources were identified as a key function in fighting fraud.

The first responsibility was about creating the right culture. Stakeholders felt that the starting point was establishing a healthy work/life balance, building notions of quality of life beyond simply remuneration.

Adequate training in compliance policies was important, but so were empowerment measures, building awareness, and encouraging employees to feel able to take personal responsibility for upholding ethics.

An ethics code should form the basis of employee education. Employees should be incentivised to uphold it. And good practice should be made visible within the organisation. Some companies reported putting ethical behaviour on the record, identifying 'heroes' in recognition for their ethical behaviour.

At the same time, breaches of the ethical code should be taken seriously.

CSR And Social Investment

Private sector fraud is a core business matter, of central concern to the board, CFO and compliance teams. However, Corporate Social Responsibility was identified as an important supporting activity, by both business and government stakeholders.

The emerging idea was that companies could promote the spread of ethical activities, and strengthen governance, transparency and accountability in the communities and markets they operate in.

Stakeholders felt that fighting corruption was a corporate social responsibility. And as such, companies should advocate for fighting corruption to be included as a legitimate area for them to meet their mandatory CSR spend, under the new guidelines.

Legitimate areas for social investment were identified as:

- Empowering communities to hold public sector delivery to account
- Strengthening ethics curricula and teaching in management and legal education institutions
- Supporting community governance programmes

It was also recognised that CSR spend can fuel corruption, with money going to nominees of government officials, or simply being mis-allocated. It was therefore seen as essential that companies bring in effective monitoring and evaluation of CSR programmes, which prioritise the social impact of initiatives over the money spent.

Auditors And Business Partners

"Auditors will give a report to my liking"

The consultations involved input from national accounting bodies and from professional service firms. The first thing to emerge was that detection of fraud was not seen as part of auditing firms brief. There was agreement that fraud was built around shadow accounts, and therefore outside the purview of auditors. But at the same time, those in the profession were keen to reinforce their responsibility to highlight mis-reporting or other concerns.

There were opportunities though for detecting fraud through the triangulation of data. It was explained that companies engaged in fraud will often provide different Profit and Loss figures to different bodies. The examples given were those figures given to banks, when applying for credit, versus those given to auditors for tax purposes. Company accounts are in the public domain. Banks were encouraged to compare data submitted to them with that in company reports.

Shareholders

Both shareholders and stock exchanges were seen as having a role in providing a check on private sector fraud.

It was suggested that stock exchanges in India should be more involved in the implementation of external anti-corruption policies, as seen in case of Securities and Exchange Commission in the USA. SEBI has brought out detailed recommendations about disclosure of pledged shares – something identified by the research in this study as being a flag worthy of further investigation. Highly leveraged companies were recognised as being under pressure to maintain earnings – another potential driver for fraud.

Participants felt that shareholders must show greater diligence. The keys were seen as encouraging shareholder education and empowerment so they can ask pertinent questions. Many felt that ordinary shareholders can't decipher a company's Annual report. Again, stock exchanges had a duty to insist that reports that are filed in various stock exchanges should be in simple language which can be easily understood by a general investor.

Government Side

Each of the consultations had representations from government. Officials from the Department of Personnel and Training and from the Rajya Sabha secretariat presented on the government's legislation plans. State-level vigilance leads from the Comptroller Auditor General's office, from Income Tax and from Police shared their perspectives on compliance within government. All exchanged ideas with peers in business on how to improve transparency and compliance, in both the business sector and in government.

Legal Framework for Transparent Business

There was discussion of the government's plans to bring in new legislation criminalising bribe paying by companies. India's ratification of the UN Convention Against Corruption was raising expectations internationally for the Government to introduce 'supply-side' measures, to tackle the role of business in corruption and to strengthen whistle blower protection.

Business participants felt the priorities were not on new legislation but on enforcement. Strengthening the judiciary was identified as a priority. As was creating a separate judicial system for white-collar frauds for speedy prosecutions. The key from the business perspective was for Government to reduce the cost of compliance and increase the cost of non-compliance.

One area not currently being looked at is the formulation of companies. Some participants felt a clause covering transparency and anticorruption could be added to the articles of association for all new companies created.

The participants voiced concern over the multiplicity of regulators in India. This creates a challenge both from an enforcement perspective and from a compliance perspective. But participants also felt it presents an opportunity. With companies providing information to a variety of regulators, and investigators generating additional data, there is a lot of information in the public domain. Information which can, potentially, throw up inconsistencies reveal a problem within a business.

"India is legislating – we can guide the debate"

Increasing government resilience to Corruption

Just as companies need to set the right tone at the top, all stakeholders felt that the environment in which business operates had a bearing on its own levels of transparency and compliance. Building the resilience of government to corruption was therefore seen as an essential component in creating the conditions for better governance within business.

Transparency and clear processes for decision-making was seen as the starting point. Participants felt that decision making was often dis-incentivised. Civil servants were encouraged to keep contemporaneous records of the decision making process, with clear explanation of the reasons for decisions taken.

The qualities and values of individual were also seen as of importance. The concept shared was of 'gene therapy', posting right people in right place to positively impact the system.

Since the Pay Commission, participants felt it was no longer legitimate – if it had ever been – for senior officials to cite financial need as a reason for graft. Senior government participants were encouraged to promote compliance within their departments and to reward corruption resilience. The time frame for delivering decisions could be benchmarked and standards set.

Stakeholders called for greater transparency in the personal assets of public officials – through a declaration on taking up a post and on leaving office.

Approaches to Vigilance

Government representatives described a move in vigilance from punitive, to preventative, to participative vigilance.

Punitive Action

Orissa and Bihar have introduced powers to confiscate property – the only states in India to do so. However, applying these powers is a challenge. And punitive vigilance remains the most expensive approach.

One government officer listed these areas as being of the highest risk in his state, and therefore attracting most investigative attention:

1. Engineering Department
2. National Resource Allocation Department – Sand, Wind, Land, Coal
3. Public Service Delivery programmes – in the Employment, Education and Health sectors
4. Acts of omission

Preventative Action

This was seen as a more cost-effective approach, and one where ICT (Information and Communication Technology) was having an increasing impact. For example, the employment of ICT has reduced the interaction between the Income Tax officials and citizens with an objective of reducing instances of bribery.

A simple checklist for preventing corruption was shared with participants:

1. Examine every procedure and remove bottle necks
2. Prepare standard operating procedure for all
3. Teach conduct rules to all staff
4. Insist on everyone giving annual property returns

Participative Action

Those involved in Vigilance in government argued that preventative, detective and punitive approaches had proved not to be enough – reformative measures are required if corruption is to be reduced.

The government is also making several anti-corruption policies as a participatory move to involve the private sector as well as civil society in curbing corruption.

Whistle Blowers

Whistle blower protection came up at all the consultations, on both the government and corporate side, with common themes.

Whistle-blowing is typically resisted because of

- Ignorance of protection mechanism
- Fear of reprisals
- Fear of motivated reports clogging the system
- Confidentiality compromises
- Exposure or risks for the entity

Stakeholders felt that greater adoption of whistle blowing mechanisms and better protection for whistle blowers was required.

Companies should give whistle blowers anonymity, by outsourcing the mechanism. And whistle blowers should be rewarded if vindicated.

Technology was increasingly being used by leading companies to bring in greater transparency to mechanisms, while preserving anonymity.

India does not have many laws pertaining to whistle-blowers; Clause 49 of the Listing Agreement briefly touches upon it – saying that companies could introduce whistle blower protection. This was contrasted with

Sarbanes Oxley, which states that companies must provide whistle blower protection, and has penalties for whistle blower reprisals.

Companies also felt that whistle blowers in government needed protecting. A number of companies argued for a collective fund, created by companies, to provide legal protection to individuals in government who blew the whistle on government-side corruption.

“Can we create a fund to protect whistle blowers along the same principles as the international oil pollution compensation fund? To provide protection for whistle blowers and protect against this pollution called corruption.”

The Consultations can be best summed with the quote from a key stakeholder:

“We always ignore corruption in private sector. But there is large-scale fraud. We must aim to understand fraud in private sector. We always take an economic view of corruption. We should also look at the moral question. The whole purpose of this exercise is to make us think.”

FRAUD AND CORRUPTION: MECHANICS AND PERSPECTIVES

Mechanics of Fraud and Corruption

Corruption money payments or bribe taxes as per one of the media post tantamount to a whopping 6% of GDP of the Indian economy during 2010-2011.⁶⁵ The extravaganzas witnessed in these payments raises two crucial questions, first how are such funds generated and how do these entities conceal such enormous transactions in books of accounts. The current section looks at the modus operandi of such bribe/ corruption pay-outs resulting in instigation of frauds.

The companies generate these payments through a system of slush funds that is most of the times created prior to the actual transaction. Slush funds are created by using various illicit techniques so that the legitimate business funds are diverted to secret bank accounts in order to create a buffer for future corruption payments. These bank accounts may be maintained in the country or offshore destinations. At times these slush funds are retained in cash and are utilized as such or alternatively find an entry into the legal banking channels through money laundering activities. Some of the commonly used techniques are:

- Under invoicing of genuine business revenue transactions.
- Overstatement of expenses.
- Creating inaccurate agreements referring to non-existent services or goods.
- Fictitious service agreements with bogus or forge consultancy firms.
- Retaining export realizations overseas.

The corruption or bribe payments made by companies can be made in various forms in cash or kind. The payments in kind encompass gifts and favours such as lavish entertainment, free transportation on corporate jets, free hotel stays, paid vacations etc. The payments in cash may be made in hard currency or through wire transfers or through cheques. In the current section we will essentially look at the second category.

Bribe payments are generally disguised in the payers' books as legitimate business transactions, mostly through a web of transactions hiding the true identity of the beneficiaries and making it extremely complex to trace. It would be pertinent to note here that both generation and payment of corruption money involves money laundering activities whereby the identity and origin of illegally obtained money, such as bribes, are concealed or disguised. Further beneficiaries take steps to make illegally obtained money to appear as if it comes from a legitimate source.

Transfer of funds and payments during corruption can take place in following manner:

1. Loan transactions

The payments made to a beneficiary are shown as a loan with or without interest. The amounts so recoverable are carried in the balance sheet as such for a long period of time. There is no intent to recover such outstanding and most of the times are written off as bad debt or a non-recoverable asset.

The company may also make an actual loan but at favourable conditions such as zero interest or for longer tenor.

2. Related Party Transactions

Related parties such as promoters, subsidiaries, joint ventures etc. may be used to channel funds from the payer to the beneficiary. For instance holding company may instruct the subsidiary company to make payment directly or indirectly to the concerned entity on the pretext of certain deceptive invoices. The subsidiary company may or may not get reimbursement from the holding company. This circuitous route of payments made via related parties through domestic and at times off shore entities adds further level of ambiguities and complexities to transactions.

64 http://articles.timesofindia.indiatimes.com/2010-12-09/india/28238249_1_bribe-transparency-international-international-anti-corruption-day

65 <http://www.firstpost.com/economy/real-scam-we-pay-rs-400000-cr-in-bribe-taxes-a-year-434656.html/2> last accessed on January 4, 2013

“One person in four worldwide paid bribes and 54 per cent Indians said that they greased the palms of authorities to get things done during the year 2010.”

Transparency International, Report 2010.⁶⁴

3. Capital market transactions

The company may transfer a hidden interest in a joint venture or other profit making enterprise to the beneficiary or its associate at nominal value or no consideration. The companies may issue sweat equity virtually with no services rendered in lieu of the illicit favours received conferring share in profits to the beneficiary. At times convertible / non-convertible debt securities or instead equities out of promoters' quota are issued at much favourable conditions than the common investor.

In these cases the beneficiary, in supplement to one time receipt of money obtains dividend or share in profits for a long period of time in return of the illicit favours.

4. Especially structured transactions

The companies may float special purpose vehicle shell companies to facilitate such payments through a web of clandestine transactions inhibiting the identity of the beneficiary and ensuring anonymous money trail. These corporate entities are mostly unnecessarily and unjustifiably complex multi-tiered entities with ownership spread across other corporates with in the country or offshore destinations.

5. Payments made through agents/ distributors

In this case payment is made to an intermediary such that there is no direct trace leading from the company to bribed official.

An intermediary may be a relative, business associate or close friend; alternatively a business consultant who does not provide any identifiable or economically justifiable services; alternatively may provide a combination of both legitimate and illegitimate services. An intermediary may be appointed by a subsidiary company or subsidiary company may itself become an intermediary.

The intermediary operates under the complete control of beneficiary and payment is transferred either on a standalone or through layers (cascade) of intermediaries to actual beneficiary.

Further to justify the payment to an intermediary fictitious book entries such as false invoices for purported goods or services received are created. Fake documentation with deceptive contracts, ingenuine invoices containing non descriptive terms and conditions or vague language is the common feature across all types of intermediaries' agreements.

6. Payments made to trusts

The corruption money may transfer from the payer to a trust which has beneficiary or one of its associate as the trustee. In most of the cases trust has no legitimate business or social cause but is especially operated for receipt and diversion of graft money. These trusts have benami ownership with real ownership interest difficult to ascertain and establish.

At times these trusts are formed as non-profit organizations with charity or social cause as primary objectives but are mostly used as vehicles for ill-gotten money and money laundering.

7. Transfer of assets at values other than fair market value

The company may transfer its movable or immovable assets to the beneficiary at values other than fair market value. Alternatively the company may buy assets from the beneficiary or its associates at exorbitant prices much higher than their economic value, thereby transferring consideration much higher than warranted.

Thus to conclude the corruption money is transferred using sophisticated and complicated network of individuals or entities with transactions meticulously planned and executed such that the intricacies impede detection.

Gatekeepers of Fraud Detection

The gatekeepers monitoring and investigating frauds have different perspectives on means, motives and procedures for conduct of fraud. In section, we present perspectives of the Indian and US gatekeepers towards corruption and fraud in the private sector.

Indian Perspective

Serious Fraud Investigation Office (SFIO)

The annual report of the MCA for 2011-12⁶⁶ mentions the different types of fraud observed by SFIO in their investigations. Presented below is a summary of the analysis provided in the report:

(a) Financial Statement Fraud

In this kind of fraud, SFIO finds that fraudulent companies prepare two different sets of financial statements for different regulatory authorities. Such companies showed different profits by valuing inventory differently or booking fraudulent sales in the two different sets of accounts. In few companies, it observed that they did not capitalize assets despite starting commercial production. In some fraud cases, SFIO, found that:

"By following two accounting years, the company was showing losses or very nominal profit in the Profit & Loss account filed to the Income tax department. However, huge profit was being shown in the Profit & Loss accounts filed with stock exchanges, ROC etc".⁶⁷

(b) Capital Market Fraud

SFIO find various modus operandi for capital market frauds, for example in one case a company created capital by circulating back-to-back cheques with associate companies, another by doing an equity swap with a dummy/dormant company,

another by swapping shares against preference shares of an associate company at a huge premium and another by colluding with another company by issuing shares in each other's company reciprocally without exchange of money & then selling such shares. SFIO concludes that general trend of involvement of the promoters of the company through preferential allotment of shares to them by method of circulation of cheques or swapping. It points that:

"promoters often resort to selling their shareholding in the company at manipulated prices to make illegal gain from share market and later, repurchase the same at reduced price by reversing the process in the subsequent period and thus continue to maintain their control on the company".⁶⁸

(c) Fraud in Project Funding

The SFIO has also found cases where companies fraudulently siphoned off money given to them by financial institutions for setting up Industrial projects. In one stance of fraud, SFIO found that a subsidiary company in India siphoned off working capital investment by procuring their major raw material from its main overseas company at very highly inflated prices. SFIO observed that:

"Company imported second hand plant and machinery from its parent company at a very high price. This over-valued plant and machinery was used to obtain higher term loans from funding institutions. The loan amount thus obtained was transferred to the parent company as payment liability against such plant and machinery. It was noticed that the Indian company had received different invoices for submission to different Government agencies for majority of its machinery."⁶⁹

66 Annual Report 2011-12, Government of India, Ministry of Corporate Affairs. Page 5

67 Annual Report 2011-12, Government of India, Ministry of Corporate Affairs. Page 35

68 Annual Report 2011-12, Government of India, Ministry of Corporate Affairs. Page 36

69 Annual Report 2011-12, Government of India, Ministry of Corporate Affairs. Page 35

(d) **Fraud through Fake Invoices and Bills**

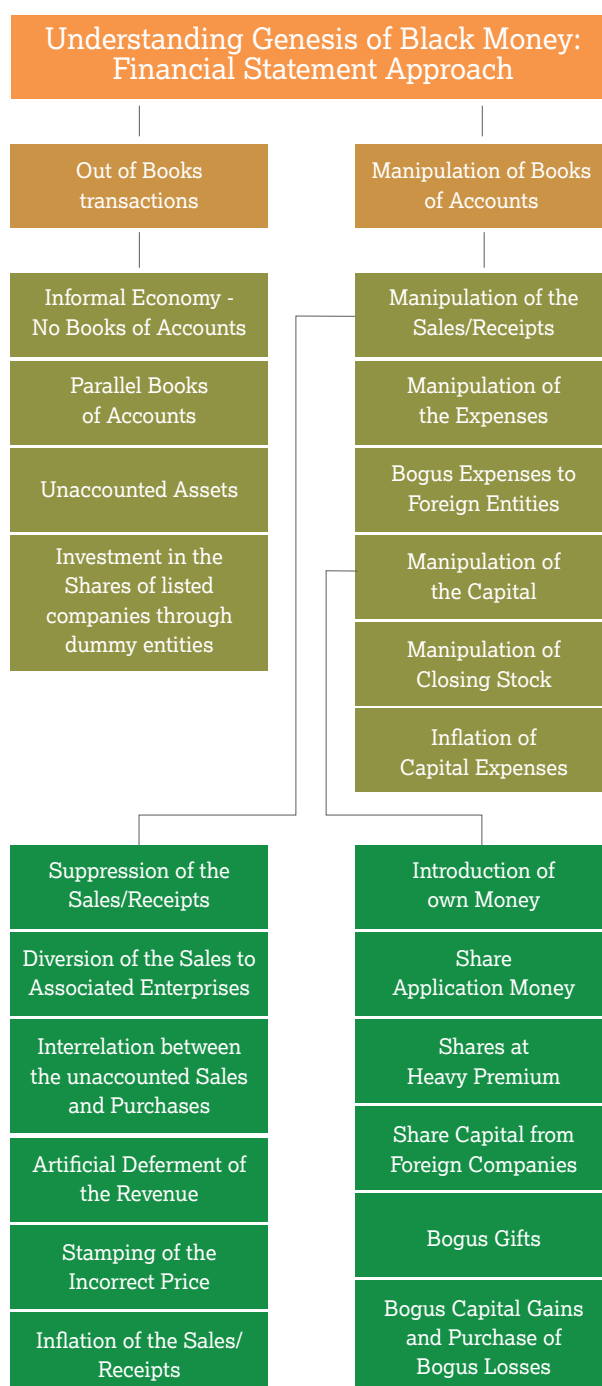
The SFIO also found cases where large purchases were made from petty suppliers or group companies and material received was shown under work-in-progress. Most of these suppliers were either non-existent or had subsequently been wound up. The report mentions that “Funds transferred to these entities showing the supply of material were found to have been taken out in cash by rotating through certain accounts are showing payments for certain non-verifiable expenses.”⁷⁰ In one case it was also found that some group companies were doing circular trading raising fake invoices without transfer of goods. They subsequently got the fake invoices discounted by banks and after some initial payments, stopped making payments and the promoter absconded with a large sum of money leaving bad loans for the banks.

Central Board of Direct Taxes (CBDT): Tax

In a white paper issued in 2012 on ‘Black Money’ by the Government of India, Ministry of Finance, Department of Revenue, CBDT conceptually described how different kinds of manipulations of financial statements⁷¹ result in tax evasion and generation of black money thus describing the dynamics of corporate fraud.

The white paper by tax regulator on points that ‘black money’ is generated through legitimate economic activity, primary either through i) manipulation of accounts; or ii) out of book transactions.

The schematic diagram given below shows how companies perpetrate corporate fraud by manipulating the financial books of accounts.⁷²



70 Annual Report 2011-12, Government of India, Ministry of Corporate Affairs. Page 35

71 Black Money. White Paper 2012. Ministry of Finance. Department of Revenue. CBDT, New Delhi.

72 Black Money. White Paper 2012. Ministry of Finance, Department of Revenue. CBDT, New Delhi. Pg 4

The US Perspective

The Committee of Sponsoring Organizations (COSO) of the Treadway Commission⁷³ conducted comprehensive study on alleged 294 cases of fraudulent financial reporting by US public companies from 1998 to 2007 investigated and prosecuted by the SEC is based on Accounting and Auditing Enforcement Release (AAER).

The SEC named the CEO and/or CFO for some level of involvement in 89 percent of the fraud case sin 1998-2007, up from 83 percent of cases in 1987-1997. Within two years of the completion of the SEC's investigation, about 20 percent of the CEOs/CFOs were indicted and over 60 percent of those indicted were convicted. The most common fraud technique involved improper revenue recognition, followed by the overstatement of existing assets or capitalization of expenses. Revenue frauds accounted for over 60 percent of the cases in 1998-2007, versus 50 percent in 1987-1997. The SEC's observed that most commonly cited motivations for fraud included : need to meet internal or external earnings expectations, an attempt to conceal the company's deteriorating financial condition, need to increase stock prices, need to bolster financial performance for pending equity or debt financing, or the desire to increase management compensation based on financial results.

⁷³ Fraudulent Financial Reporting: 1998-2007 – An analysis of U.S. Public companies (2010) <http://www.coso.org/FraudReport.htm>

FRAUD AND CORRUPTION: MECHANICS AND PERSPECTIVES

- Various ways through which transfer of funds takes place during fraud and corruption includes: loan transactions, related party transactions, especially structured transactions, payments made through agents/distributors, payments made to trusts, transfer of assets at value other than fair market value.
- From MCA perspective, SFIO points that four different types of frauds: financial statement fraud, capital market fraud, fraud in project funding, fraud through fake invoices and bills.
- From tax regulator perspective, CBDT observes that black money is generated either through manipulation of accounts or through out of book transactions.
- From the US securities market regulator – SEC perspective corporate frauds mainly take place through improper revenue recognition, overstatement of existing assets, and capitalization of expenses.

DETECTING FRAUD AND CORRUPTION: CHALLENGES FOR OVERSIGHT IN INDIA

The economic liberalization started in 1991 dismantled of an elaborate system of inspectors who gatekeepers of 'license-permit raj'. In fact the terror of such inspectors and the lower bureaucracy was so large that it was also sometimes referred to as the 'inspector raj'.

Since early 2000, the Government of India introduced computerisation in the various services offered to the citizens bring in greater efficiency and transparency. These e-governance initiatives have not only made government services more accessible, but also ensure their efficiency, transparency and affordability. Further, by reducing the discretion of lower bureaucracy, it also impacted the day to day corruption otherwise prevalent in such transactions. However, this does not mean that corruption has disappeared from India. The decrease in 'petty' corruption has been more than compensated by the rise in 'grand' corruption as the recent scandals have shown. It is true that liberalization has provided even larger opportunities to corporations who are more than willing to use both fair and unfair methods of winning favour with the government.

A major role in this exposure has been played by the Right to Information Act (RTI) of 2005, which empowered citizens to query the Government on anything with exception on matters related to national security. Initial attempts to utilize its provisions have had a mixed response from authorities but as the citizens have understood the power of this tool, it is bringing out more instances of corruption into the public domain.

Besides the act, the constructive role being played by some of the watchdogs like the office of the Comptroller and Auditor General of India (CAG) as well as the higher judiciary have also ensured that the problem of corruption will not be swept beneath the carpet but would need to be firmly dealt with. The challenges however still remain.

Corporate Regulators in India

In India, there are multiple regulators such as the Securities and Exchange Board of India, the Reserve Bank of India and the Institute of Chartered Accountants of India that are responsible for enforcement of corporate laws.

These regulators have been bestowed with the powers to, investigate, issue of a summons, prosecute and levy penalties.

In the case of SEBI, the body that regulates the capital markets, data related to the duration of investigations and prosecution of corporate frauds throws up some very interesting insights.

Corporate conduct is overseen by multiple gatekeepers who act on different aspects of business transactions. Gatekeepers operate in an interdependent rather than an independent manner and it is important to have a certain degree of collective responsibility among all gatekeepers to harness their total capacity to deter wrongdoing. A regime of fault based liability coupled with joint and several liabilities would be optimal for advancing the cause of optimal deterrence.⁷⁴

The current system involves half a dozen apex regulatory agencies, apart from several ministries in the government that retain direct regulatory powers. This structure leads to major regulatory overlaps and gaps. Some examples of regulatory overlap include, overlap between SEBI and MCA in the regulation of the issuer companies; overlap between SEBI and RBI in the regulation of foreign institutional investors as well as in exchange traded currency and interest rate products; overlap between RBI and state governments in the regulation of cooperative banks. This sometimes leads to regulatory arbitrage and regulatory capture.

Further, one of the Planning Commission Report⁷⁵ point that regulators suffer from conflicts of interest, such as, a desire to protect certain kinds of institutions and certain forms of ownership. They confront immense heterogeneity in the entities they regulate, as well as in the investors and customers whom they protect.

74 Multiple Gatekeepers, Andrew F Tuch, discussion paper no. 33, 3/20120, Harvard Law School, Cambridge, MA

75 A growth friendly regulatory framework, available at: http://planningcommission.nic.in/reports/genrep/rep_fr/ch6_fr.pdf, last accessed on October 5, 2012

Coping with Corruption and Fraud: Challenges of Indian Legal and Regulatory System

The efficacy of the legal system can be comprehended in terms of enforcement of the contracts. A 2012 report of the World Bank⁷⁶ on “Doing Business” has ranked India at 182nd position worldwide in terms of enforceability of contracts, at bottom of the table. Laws included in sections of the IPC and those pertaining to anti-fraud measures are not specific and stringent. 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. Out of these 1,420 days the trial and judgement take up the maximum time of 1,095 days and enforcement of the judgement takes another 305 days.⁷⁷ This reflects weakness of the Indian legal system, and which large extent suffices the corruption problem in the country.

In the country, there are substantial delays in the Indian legal system and a large number of pending cases. A research paper by PRS Legislative Research places the number of pending cases in India, as of July 2009, at 53,000 with Supreme Court, 4 million with various High Courts, and 27 million with various lower courts. As compared to the pending cases in January 2000, this reflects an increase of 139 per cent with the Supreme Court, 46 percent with High Court and 32 percent with lower courts. Further, since the numbers of fresh cases added every year are larger than those being resolved, there is obviously a shortfall in the delivery of justice, and a consequent increase in the number of cases pending.⁷⁸ Recently, the Union Law Minister, mentioned that approximately 9% of the cases have been pending for over 10 years and a further 24% of the cases have been pending for more than 5 years.⁷⁹

The conviction rate by investigating and prosecuting

agencies is quite low. One of the Standing Committee Report of the Parliament noted that “conviction rate in criminal cases is as low as ten percent due to perjury. Perjury is committed by the witness on his/her own volition or under threat/ allurements/ inducement of third party”.⁸⁰ In all the cases reported under criminal breach of trust and cheating (i.e. economic crimes), the conviction rate is 31.2% and 27.5% respectively as per National Crime Records Bureau, in 2011⁸¹. Inability of regulatory system to convict a corrupted person takes out bite to deal effectively with corruption and fraud.

India has several regulators to deal with cases of corruption and fraud. The multiplicity of agencies and laws in India seems to be creating hurdles for regulators to effectively detect, investigate and prosecute corporate frauds. Multiplicity of regulators creates severe problems in inter-agency coordination. Coordination problems are aggravated by the variation in skills and experience of regulators.⁸² The multiple investigations on each fraud and involvement of a large number of people results in lack of accountability, delays and provides the ‘opportunity’ to the fraudsters to cover up their trails, manage witnesses and delay prosecution.

Investigating agencies and regulators in the country face with severe resource crunch of experienced professionals. Given the heavy workload and diversity of cases it is not appropriate to expect the CBI to play a premier role in investigating fraud. In fact the SFIO was envisaged to be the premier corporate fraud investigating agency in India. However, it currently does not have powers to initiate an investigation into a corporate fraud except for some minor offences nor does it have other police powers, making it dependent on the CBI for criminal investigations.⁸³ The proposed Company’s Act 2011, which has been in the works since 2009 post the Satyam scam, incorporates several stringent measures/changes, including greater powers to the SFIO, to plug some of the existing weaknesses in the system.

76/6 <http://www.doingbusiness.org/data/exploreeconomies/india#enforcing-contracts>

78 Corporate Governance in India. From Policies to Reality. By IICA, TARI & IIMC. Pg. 22

79 Text of Speech – Union Law Minister on the programme to reduce pendency in courts (July 1, 2011), <http://pib.nic.in/newsite/erelease.aspx?relid=72970>

80 Rajya Sabha standing committee report on home affairs on Amendment of Criminal Law (Amendment) Bill 2003. Pg 6.

81 Figures at a glance 2011. <http://ncrb.nic.in/>

82 A growth friendly regulatory framework, available at http://planningcommission.nic.in/reports/genrep/rep_fr/ch6_fr.pdf, last accessed on October 5, 2012

83 http://articles.economicstimes.indiatimes.com/2011-05-22/news/29571284_1_sfio-investigation-satyam-fraud-case

Dealing with Corruption: The Way Forward

Overall, the Indian judicial and enforcement system are marred by inordinate delays due to multiple investigations by different agencies and also the time taken to file charge-sheets. Prosecutions may take even longer, with a low conviction rate, thus not working as an effective deterrent. The delays and low rate of conviction in India may act both as 'rationalisation' and a 'motivation' in the minds of the perpetrators of fraud as they feel that they can get away with corruption and fraud and that 'crime does pay'.

There are also certain weaknesses in the legal framework as well as the regulators and investigating agencies. Investigating agencies in India may leverage technology to improve their own efficiency in the same manner as the SFO in UK, which has been able to reduce the time of first charge for cases of frauds from 48 (plus) months five years ago to 19 months now.⁸⁴ Updates on legal cases should also be shared by the investigating agencies with the public on their websites. This information will also provide inputs to the policy/lawmakers regarding the loopholes that they need to plug in timely administration of justice.

Currently, just sifting through multiple charge sheets and court orders to keep track of the final out-comes of a cases of fraud is a herculean task and needs a more professional and systematic approach. Investigating agencies need to create a knowledge repository comprising of every single case of fraud. They should be able to use this information in a cogent and organized manner not only to facilitate and expedite prosecutions, but also use it as a tool for development of training and enhanced learning for the future.

The government is however trying to bring in changes to take care of these problems. The proposed Companies Act and Public Interest Disclosure (Protection of Informers) Act are steps to deal with corruption and fraud problem.

A predictable, competitive, and fair economic environment which is free of corruption is central to sustainable business, economic growth and national development and can be achieved through measures mentioned above.

84 www.sfo.gov.uk

DETECTING FRAUD AND CORRUPTION: CHALLENGES AND WAY FORWARD PERSPECTIVES

- The Government of India initiatives, such as RTI Act 2005 and on e-governance, constructive role played by the CAG of India, and greater judicial involvement have been some of the steps towards coping with widespread corruption prevalent in the last century in India. However, challenges still persist.
- In India, multiple regulators, such as SEBI, MCA, and RBI exist with overlapping domains.
- Significant challenges prevail in the Indian legal and regulatory system: enforcement of contracts and delay in the judicial system, low conviction rate of corrupt people, multiplicity of regulators and investigating agencies and lack of skilled resource person.
- The way forward to deal with corruption – leveraging technology, more skilled resources for investigating agencies, better co-operation and coordination between multiple agencies, greater efficiency of the judicial system.

GOOD PRACTICES FOR MAINTAINING ETHICAL BEHAVIOUR

The previous chapters of this study mentioned that both the incidence and magnitude of fraud have been increasing in the past few years. In this chapter, we shall delve into the practices and processes of staying ethical so as to prevent and neutralize the ill effects of fraud and corruption.

It is widely recognized that corruption takes place with the tacit cooperation of both businesses and government. The literature on corruption, and anti-corruption conventions and agreements unambiguously maintain the need for a multi-sectoral collaboration in addressing corruption.⁸⁵

Business against Corruption

The International Chamber of Commerce, Transparency International, the United Nations Global Compact (UNGC) and the World Economic Forum Partnering Against Corruption Initiative (PACI) have jointly come out with a document titled “Clean Business is Good business: A Business Case Against Corruption.”

The document estimates that on an average corruption increases the cost of doing business by up to 10%.⁸⁶ It further estimates that corruptions adds 25% to the cost of procurement contracts in developing countries. This means that the effect of moving a business from a country with relatively low corruption to one with medium to high corruption is equivalent to a 20% tax on foreign business.⁸⁷

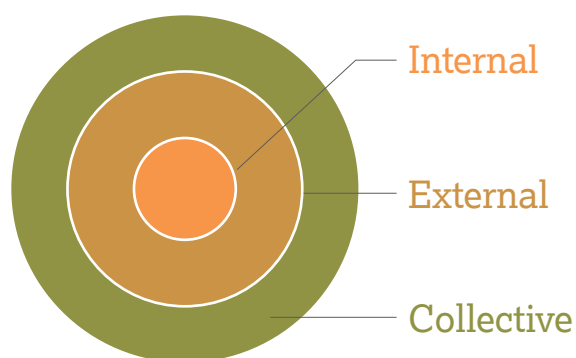
Private companies run the risk of reputational damage, fall in market value if listed on stock exchanges, blacklisting from government contracts and penalties if their participation in corruption and fraud gets exposed. Siemens, the German engineering giant, had to pay penalties of US\$ 1.6 billion in 2008 to settle charges that it engaged in bribery around the world. Further, despite

paying bribes, uncertainty still exists about whether the company will get the intended business benefit and to what extent.

The document further suggests that engaging in ethical practices could reduce the cost of doing business, attract highly principled employees and ethically concerned customers as well as vendors.

UNGC has adopted certain guiding principles for businesses, of which the tenth principle is “Businesses should work against corruption in all its forms, including extortion and bribery”.⁸⁸ UNGC further urges businesses to develop policies and concrete programs to address corruption and to join hands with governments, UN agencies and civil society to realise a more transparent global economy.

UNGC suggests the following three elements to fighting corruption:



1. Internal: As a first and basic step, introduce anti-corruption policies and programs within the organization and business operations;
2. External: Report on the work against corruption in the annual Communication on Progress; and share experiences and best practices through the submission of examples and case stories;
3. Collective: Join forces with industry peers and with other stakeholders.

85 Towards better corporate governance, a handbook on developing anti-corruption programme, Hills Governance Centre, available at : <http://www.rvcvstarr.aim.edu/Library%20CV%20Starr/Center%20Publications/Towards%20Improved%20Corporate%20Governance.pdf> last accessed on October 11, 2012

86 <https://members.weforum.org/pdf/paci/BusinessCaseAgainstCorruption.pdf>

87 <https://members.weforum.org/pdf/paci/BusinessCaseAgainstCorruption.pdf>

88 <http://www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/principle10.html>

The current chapter has been similarly organized, whereby in the first section (internal) we would be discussing the internal actions that can be taken by businesses, the second section looks into the role of the government and regulators (external) and their interface with business and in the final section business and other social groups' joint responsibility (collective) to fight fraud and corruption.

Measures Against Corruption

Internal Measures

There are numerous tools and practices available to business to prevent and/or control fraud and corruption. These are discussed below.

1. Internal Control

A robust, dynamic internal control system can help businesses adapt and fight against the nuisance of fraud risk. COSO defines internal control as a "process, affected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives with regard to effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations."⁸⁹

It further clarifies that, internal control is a process. It is a means to an end, not an end in itself. Internal control is not merely documented by policy manuals and forms. Rather, it is put in by people at every level of an organization. Internal control can provide only reasonable assurance, not absolute assurance, to an entity's management and board. Internal control is geared to the achievement of objectives in one or more separate but overlapping categories.

One of the significant steps towards building a robust internal control system is changing employee attitudes towards the relevance and advantages of adapting it. Building attitudes bears its genesis from the tone at the top. According to the Institute of Internal Auditors, "Responsibility for the system of internal control within

a typical organization is a shared responsibility among all the executives, with leadership normally provided by the Chief Financial Officer." An internal control system should unambiguously define or clarify ownership roles and responsibilities relentlessly through effective communication channels and appropriate demarcation of jobs & responsibilities.

Given the ever changing business and regulatory environment and the number and diversity of frauds being committed against companies globally, internal controls must be reviewed, evaluated, tested and strengthened regularly. It's insufficient to create internal controls and expect them to stand the test of time without periodically modifying them to meet current conditions.⁹⁰

2. Code of Conduct

The board and senior management should communicate their commitment to fraud risk management by establishing and implementing organization's values or principles and code of conduct.⁹¹

3. Tone at Top

American sociologist Edwin Sutherland, in his theory on fraud and corruption known as Differential Association Theory, published in *White Collar Crime* (1949/1983),, stated that "Criminal behaviour is learned in association with those who define such criminal behaviour favourably and in isolation from those who define it unfavourably, and a person in an appropriate situation engages in such criminal behaviour if, and only if, the weight of the favourable definitions exceeds the weight of the unfavourable definitions." Therefore, the executive management must set the tone at the top and model the highest level of integrity.⁹²

89 <http://www.coso.org/resources.htm>

90 <http://www.csoonline.com/article/678375/fraud-prevention-improving-internal-controls-> last accessed on October 10, 2012

91 COSO report

92 <http://www.theiia.org/theiia/about-the-profession/internal-audit-faqs/?i=3087> last accessed on October 10, 2012

Top management should demonstrate both by words and action the acceptable behaviour thereby by setting an ethical environment with zero tolerance for fraud for others to follow such that fraud risks can be mitigated.

4. Fraud Risk Assessment Programme

Fraud risk management program depending on the size and nature of an organisation should include roles and responsibilities, commitment, fraud awareness, affirmation process, conflict disclosure, fraud risk assessment, reporting procedures and whistle blower protection, investigation process, corrective action, quality assurance and continuous monitoring.⁹³

5. Role and importance of Whistle blower

The Public Company Accounting Oversight Board (PCAOB) has recommended establishing a whistle-blower hotline to mitigate the risk of management override of internal controls.⁹⁴ Corporate fraud is more likely to be detected by an employee from within a firm, rather than external auditors, government regulators, self-regulatory organizations, or the media.⁹⁵ According to a PricewaterhouseCoopers survey, while professional auditors were only able to detect 19% of the frauds on private corporations, whistle blowers exposed 43%. The executives surveyed estimated that the whistle blowers saved their shareholders billions of dollars.⁹⁶ PricewaterhouseCoopers' survey is consistent with statistics released by the U.S. Department of Justice, demonstrating that employee whistle blowers are responsible for detecting the majority of civil frauds.⁹⁷ The 2012 Report to the Nation on Occupational Fraud and Abuse by the Association of Certified Fraud Examiners (ACFE) found whistle-blowing (tips) from

employees, customers, vendors, and other sources remained the most common detection method (43.2% up from 40.2% in 2010). ACFE also recommended, providing individuals a means to report suspicious activity as a critical part of an anti-fraud program. Fraud reporting mechanisms, such as whistleblowing hotlines, should be set up to receive tips from both internal and external sources and should allow anonymity and confidentiality. Management should actively encourage employees to report suspicious activity, as well as enact and emphasize an anti-retaliation policy.⁹⁸ In this regard some studies have also recommended providing financial incentives to whistle blowers, or adequate compensation and complete protection against losing their jobs or other related harassments.⁹⁹

6. Deterrence Mechanism

As a deterrent, organizational policies should reflect the consequences and processes for those who commit or condone fraudulent activity. These consequences may include termination of employment or of a contract and reporting to legal and regulatory authorities. The organization should articulate its right to institute civil or criminal action against anyone who commits fraud.¹⁰⁰

7. Detection Plan

An organization may determine that it is more cost-effective to design its controls to detect rather than prevent certain fraud schemes. It is important that organisations consider both fraud prevention and fraud detection.¹⁰¹

93 COSO report

94 Detect and prevent financial fraud available at <http://www.mncpa.org/publications/footnote/2011-04/detect-and-prevent-financial-statement-fraud.aspx>

95 <http://pogoblog.typepad.com/pogo/2010/04/who-discovers-more-corporate-fraud-whistleblowers-regulators-or-journalists.html>

96 Economic Crime, People Culture and Controls, Global Economic Crime Survey available at http://www.whistleblowers.org/storage/whistleblowers/documents/pwc_survey.pdf

97 http://www.whistleblowers.org/index.php?option=com_content&task=view&id=102&Itemid=136

98 http://www.acfe.com/uploadedFiles/ACFE_Website/Content/rtn/2012-report-to-nations.pdf

99 <http://www.macrosilience.com/2010/03/17/employee-whistle-blowers-as-an-effective-mechanism-to-uncover-fraud/>

100 COSO report

101 COSO report

8. Audit Committee

The PCAOB has recommended establishing audit committees to mitigate the risk of management override of internal controls.¹⁰² An “Audit Committee” is a key element in the corporate governance process of any organisation. The Audit Committee is a sub-group of the board of directors formed to regularly review processes and procedures to ensure the efficacy of internal control systems to maintain high levels of accuracy and competence in the reporting of financial results. The role of the Audit Committee is to perform as a catalyst for effective and transparent financial reporting. Section 292A of the Companies Act, 1956 requires that every public company having paid-up capital of not less than Rs. 5 crores should constitute an Audit Committee of the Board. For listed companies a similar requirement is contained in Clause 49 of the SEBI Listing Agreement. The provision related to Audit Committees contained in the Companies Bill, 2011 is almost (but not in entirety) a replica of the provisions of Clause 49 of Listing Agreement.¹⁰³

9. Role of Internal Audit

The importance an organization attaches to its internal audit function is an indication of the organisation's commitment to effective internal control. The internal audit charter, which is approved by the board or designated committee, should include internal auditing's roles and responsibilities related to fraud.¹⁰⁴

External Measures

In the E&Y report titled “Fraud & Corporate Governance: Changing Paradigm in India’ based on the India Fraud Survey 2012¹⁰⁵ around 40% of the respondents blamed the inherent nature of the industry in which they operate for corruption. 33% respondents thought that lack of an effective regulatory mechanism and weak law enforcement are equally responsible for corruption. Only 34% of the respondents said that bribery and corruption was due to the ‘weak tone at the top’. This suggests that a majority of the respondents think that the causes of corruption and bribery lie outside their organisations.

Further, around 62% of the respondents are in favour of stringent disciplinary procedures and 73% said that companies should have a zero tolerance approach to bribery and corruption, for example by taking legal action against the perpetrators of fraud. This finding shows remarkable commitment of the respondents to anti-corruption, for despite the fact that a majority think the problem is beyond the boundaries of their organisation, they are willing to take action against bribery and corruption.

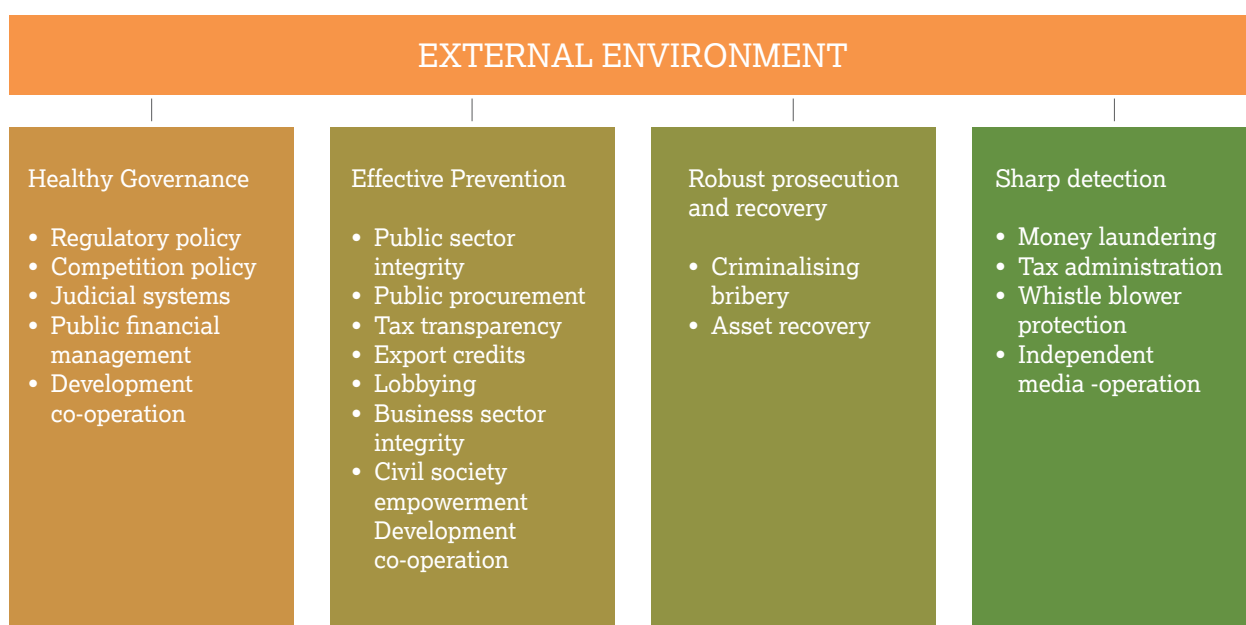
Businesses thrive in an eco-system created by the interaction of society and government. If the eco-system has problems and weaknesses, they would invariably impact the corporate as they cannot work in isolation. Despite all the efforts that corporates may make internally to curb fraud and corruption, they also have to constructively influence the environment to create a positive, transparent and fair environment to ensure that business can meet its objectives without really having to break the law or deprive society and citizens of their dues. In this section we will look at the legal environment, enforcement and government processes which can help in early detection, resolution and prevention of fraud and corruption cases. This will also help create a constructive environment for business.

¹⁰² Detect and prevent financial fraud available at <http://www.mncpa.org/publications/footnote/2011-04/detect-and-prevent-financial-statement-fraud.aspx>

¹⁰³ <http://www.caclubindia.com/articles/audit-committee-an-overview-12433.asp> last accessed on October 12,

¹⁰⁴ COSO report

¹⁰⁵ <http://www.ey.com/IN/en/Services/Assurance/Fraud-Investigation--Dispute-Services/Fraud-and-corporate-governance-Changing-paradigm-in-India>



The above picture¹⁰⁶ aptly summarises the role of various components of the external environment along with the desired features to provide governments/ enforcement agencies the necessary impetus in their prevention and detection endeavours.

We have covered some of the areas that the government needs to address as part of its responsibility to curb corruption and frauds. However, corporates are equally responsible and could contribute by:

Communicating the measures they have taken to ensure ethical operations internally to their stake-holders i.e. investors, customers, vendors and general public. Besides other information they could share their code of conduct in public communications. They should share ethical practices, their experience in implementing them and their impact with other corporates. This would help them make a smoother transition and change.

They should participate in industry forums and advocate a more ethical way of doing business so as to influence the overall business environment.

Collective Measures

In this section we look at the role of social groups and other agencies in improving the general fraud and corruption climate in a society. Clearly there is a need for an alignment of goals amongst civil society, government and business. Most democratic governments need to work for the good of the civil society and that should include development of fair and transparent economic activities through strong rule of law and a responsible private sector.

An example of goal alignment and collaborative working is the concept of integrity pacts. The CVC in the draft national anti-corruption strategy has suggested the adoption of Integrity Pacts (IP) by the private sector to help reduce corruption in public procurements.

¹⁰⁶ The picture has been taken from The Cleangov Biz Toolkit for integrity, available at <http://www.oecd.org/cleangovbiz/resources.htm>

The IP¹⁰⁷ is a tool developed in the 1990s by Transparency International (TI) to help governments, businesses and civil society to fight corruption in public contracting and procurements. They are essentially an agreement between the government agency offering a contract and the companies bidding for it that they will abstain from bribery, collusion and other corrupt practices for the extent of the contract. To ensure accountability, IPs also include a monitoring system typically led by civil society groups.¹⁰⁸

Benefits to the organization that signs an IP is that it helps enhance public trust in government contracting through transparency. It also enables companies to abstain from bribing by providing assurances to them that:

- (a) Competitors will also refrain from bribing
- (b) Government bidding system and procurement will be absolutely transparent
- (c) Government will not only prevent corruption but also extortion by their officials, and follow transparent procedures.
- (d) Helps Government and companies to reduce high cost and maintain quality control.
- (e) Creates confidence and trust in decision making process, a more hospitable investment climate, and public support in the country.

Other Measures

There is enough scope for international co-operation in the matter of greater transparency and sharing of best practices in governance mechanisms, laws and regulations. Greater co-ordination should be there between law enforcement agencies and regulators to counteract cross-border frauds and corruption. Countries should consolidate their resources and coordinate their efforts to prevent the effects of corruption from acquiring a transnational scope and should sign anti-corruption conventions and agreements.¹⁰⁹

Further, countries that offer economic refuge to a number of economic offenders through tax havens and secrecy laws need to seriously re-consider such strategies and laws. They need to provide transparency and a level playing field in such international financial transactions otherwise they are only paying lip service to the anti-corruption conventions that get signed.

107 <http://www.transparencyindia.org/resource/books/Implementation%20of%20Integrity%20Pact%20in%20India.pdf>

108 http://www.transparency.org/whatwedo/tools/integrity_pacts

109 Towards better corporate governance, a handbook on developing anti-corruption programme, Hills Governance Centre, available at <http://www.rvcvstar.aim.edu/Library%20CV%20Starr/Center%20Publications/Towards%20Improved%20Corporate%20Governance.pdf>

CASE STUDIES: GOOD PRACTICES FOR PROMOTING ETHICAL CONDUCT



TATA CHEMICALS LIMITED

TATA CHEMICALS LIMITED (TCL):

Tata Chemicals has formulated formal and informal systems of governance to ensure ethical business conduct. TCL has clearly defined the role of its leaders and employees in ethical conduct of business. The company has governance structure, organisation structure and resolution mechanism in place to cater to the grievances of the employees. The organisation structure has provided with ethical officer at every level of its functioning addressing gift and donation, whistle blowing and safety issues. TCL, also, works towards bringing about transparency in dealing with external agencies, training its employees for ethical working and the leadership is involved in regular review of its code of conduct.

SIEMENS

SIEMENS:

Since 2007, Siemens is involved in framing compliance policies by creating a process plan of prevention, detection and response. As a long term goal, Siemens is working towards eliminating the process weakness, simplifying the work process and teaching the culture of integrity to its employees. In case of misconduct, based on the severity of the cases, steps are taken; informal warning, formal warning and laying off. The compliance process is not just confined to Siemens employees but is also extended to its vendors and customers. Siemens has contributed USD 4.35 million to the United Nations Global Compact Project to promote Collective Action against corruption in key markets, including India.

Infosys[®]

POWERED BY INTELLECT
DRIVEN BY VALUES

INFOSYS LTD:

The Infosys code of conduct and the value training program enables the organization to ensure that its employees assimilate corporate and business values in their daily working. The Infosys Values Program was formulated to create awareness about the company values and engage the employees to implement these values, discuss and debate to improve the compliance policies, provide training and self-learning modules and create a cycle of feedback. The program equips the new hires with the understanding of the company values. The program also publishes anti-corruption literature, conducts surveys of the senior leadership, creates value portals and uses electronic media to spread the company's ethics.



GAIL:

In 2003, GAIL introduced a web-based centralised system called the Bill Watch System (BWS) to keep track of the vendor bills. BWS is an application for tracking the flow and status of all the bills received by GAIL. A unique receipt number generated through the system is provided to vendors at the time of bill entry in BWS. The status of each bill can be checked by the vendor online through the receipt number. The use of online forms, workflow, reporting and other tools which were a part of the BWS enabled the GAIL team to streamline their bill settlement process and reduce it from 20 days to less than 7 days.



HCL TECHNOLOGIES LTD:

HCL Technologies Limited (HCL), a software company of over US 4,4 Billion in turnover, has operations over 31 countries across the globe. HCL employs over 85000 people and has a unique ethos of “Employees First, Customers Second”, which creates a focus on employees as a key value driver for the company.

HCL reaches out to its stakeholders comprising of employees, customers, vendors and shareholders for any grievance they may have on the code of conduct of the company through a unique programme of creating an independent external Ombudsman to be focal point for receiving such compliant and working with the company for a resolution. The process provides to the stakeholders a platform for voicing their complaints and a mechanism for resolution that would be fair and without the fear of any retribution. The Ombudsman in turn reports to the Chairman of the Audit Committee.

HCL values the process they have put in place, independent of any regulatory requirement, and going by the number of resolutions believe that the voice of the stakeholders are truly heard and the resolutions take place in a time bound manner based on a Service level agreement for all concerned.



INFO EDGE INDIA LTD.(NAUKRI):

Info Edge India Limited, (Naukri) is India’s leading Internet Company with India’s most successful employment portal called Naukri.com. They also run a property portal called 99acres.com, an education classifieds portal called Shiksha.com and a matrimonial portal called jeevansathi.com. Info Edge is listed on NSE & BSE with a public float of over 47% and a market cap of about INR 38.21 billion. Info Edge has created unique ethical standards for its promoters, board members and all key employees in relation to trading of the shares of the company, beyond the requirements of the Securities laws and corporate governance conventions. The company is focused on implementing controls and processes, so that the persons in possession of sensitive information having potential to affect its share price do not take undue advantage from such information at the expense of other shareholders. The Company has instituted a system for Board Members & Officers for obtaining pre-clearance of trade above a threshold limit from Chairman of the Audit Committee & providing an appeal matrix in case the permission is denied by the approving authority.

Info Edge has also adopted a policy to regulate external commitments of its Promoter Directors which includes their strategic investments beyond a threshold limit and external directorships e.g. the Promoter Directors are not permitted to invest in internet-based businesses since those may be in conflict with the Company’s businesses, both internal and through external investments. Going a step ahead of statutory requirements, Info Edge Board comprises of a majority of Independent Directors (5 out of 9) despite having a Non-Executive Chairman, which would have meant one third Independent Directors. The compensation plan of Independent Directors has been designed to promote their participation in the Board & Audit Committee meetings by having fixed and variable components in the commission paid to them annually.

The Company has voluntarily constituted its Audit Committee with only Independent Directors as Members. Info Edge believes such practices create value for all stakeholders and reduce the risk of misuse by those in charge of governance of the company.

GOOD PRACTICES FOR MAINTAINING ETHICAL BEHAVIOUR

- Various international organizations like the ICC, UNGC, and PACI agree that corruption affects the cost of doing business, particularly in developing countries.
- Different dimensions related to fighting corruption includes: internal, external, collective and other measures.
- International measures work at organizational level which includes: internal control, code of conduct, and tone at the top, fraud risk assessment program, the role of whistle-blowers, deterrence mechanism, detection plan, audit committee, and internal control.
- External measures for dealing with corruption include creation of healthy governance policy and system, effective prevention, sharp detection with robust prosecution and recovery.
- Collective measures include the role of social groups, civil society and other organizations in improving fraud and corruption environment.
- Other measures relate to international cooperation for greater transparency and sharing of resources and best practices in governance mechanism in laws and regulations.

CONCLUSIONS

While, corruption has been present from time immemorial, focus on the issue has increased due to frequent and massive institutional failures. While developed economies like US and UK are expected to be at the forefront of anti-corruption and anti-fraud measures, even developing economies are confronting these issues head on. V. Raghunathan, mentions in his article Corruption in India and China: A study in contrast (2011) that:

“This New Year, China has announced a renewed effort to fight increasing corruption in the country. According to reports, in 2010 alone, its war against corruption resulted in no less than some 5,000 higher-level Chinese government officials — mostly above the county head level — being punished for corruption. Further, according to CCDI, again in 2010 alone, some 1,44,000 cases of corruption were investigated, leading to penalties for more than 1,46,000 lower-ranking government officials! Most of these cases pertained to officials involved in corruption, bribery and acting against public interest — much like our own.”

As per the Corruption Perception Index of 2011, published by Transparency International, India has a composite score 3.1 while China is ahead at 3.6 and Brazil is at 3.8. India's overall rank has also slipped in 2011 to 95 out of 183 countries while earlier it was 87 out of 178 countries. Meanwhile China has improved its rank from 78 to 75.

The unearthing of mega scams over the last two years which has made everybody give the issue of corruption and fraud its due focus and importance has meant that the monkey is firmly on India's shoulder and isn't going away in a hurry. In fact in the last couple of years independent India has experienced something rarely seen before i.e. politicians, bureaucrats and businessmen being jailed and tried for corruption and fraud. Future elections could well be fought and decided on the issue of curbing rampant corruption and fraud. These governance issues have had a huge negative impact on India's economic growth.

Raghuram Rajan, the chief economic adviser to the finance ministry, has said a period of rapid economic growth in which governance capabilities did not keep pace has allowed sections of the private sector to “make

a killing”. He mentioned that “The private sector to some extent took advantage of this gap — some of them through means that were fair, some through means less fair — and has made a killing”. Rajan said what was urgently needed was to bring the level of governance on a par with the level of the economy, a process that “is under way”.

Corporate Fraud

Along with the cases of corruption there has also been increased in cases of corporate fraud, in the recent years. This has brought to light the supply side of the equation and the ever present danger of this malaise. The recent trend also shows an increase in quantum of fraud with ever evolving complexity. This has created a challenge for governments, managements and society as a whole. While increased regulatory scrutiny and reforms in corporate governance have helped in unearthing several large cases of fraud in the past few years in India, the government is aware that it needs to do more. Greater independent oversight is required over the audit and accounting profession so as to improve its quality and make it a key defence against corporate frauds rather than an ambivalent watchdog which hardly provides and meaningful assurance to investors and regulators against corporate fraud.

No industry is immune to fraudulent situations and the negative publicity that swirls around them. The implication of this trend is very clear to the lawmakers, regulators, investigating agencies and managements i.e. every organization is vulnerable to fraud, and managers both of organizations and the economy must know how to predict and detect it — or at least known when to suspect it. Further, as has been proven globally, whistle-blowers need to be protected and encouraged to provide useful information in order to uncover frauds.

Global studies and trends indicate a need to keep up with changing times by leveraging technology and having strong mechanisms for detecting, investigating and prosecuting. Given that corporate frauds are becoming increasingly sophisticated with improvements in technology, the Indian investigating agencies also need

to become technology savvy in detecting and predicting frauds. There are mathematical models which can predict the probability of fraud in financial statements using GAAP and non-GAAP indicators, which can be leveraged.

They also need to create a knowledge repository comprising of every single case of fraud. They should be able to use this information in a cogent and organized manner not only to facilitate and expedite prosecutions, but also use it as a tool for development of training and enhanced learning for the future. Further, regulators and investigating agencies also need to ensure that their data collected by them is shared between them in a secure IT infrastructure for better detection using analytics and pattern-recognition.

There is also enough scope for international co-operation in the matter of greater transparency and use of information technology. Greater coordination between law enforcement agencies and regulators to counteract cross-border frauds and corruption as well as sharing of skills and resources to tackle serious economic crime should also be facilitated. Further, Investigating agencies in India need to leverage technology to improve their own efficiency in the same manner as the SFO in UK, which has been able to reduce the time of first charge for cases of frauds from 48 (plus) months five years ago to 19 months now.

India also needs to streamline the multiplicity of investigating/regulatory agencies and bringing in efficiency and effectiveness in the administration of existing regulations. It also needs to consider instituting other fast-track legal remedies/mechanisms given India's cultural context and weak legal administration to tackle the growing menace of fraud. Regular updates on legal cases should also be shared by the agencies with the public on their websites. This information will also provide inputs to the policy/lawmakers regarding the loopholes that they need to plug in timely administration of justice. The Government does recognize this challenge and some changes are on their way including strengthening the legal & the regulatory framework with new laws, rules & regulations and initiatives. These need to be operationalized as soon as possible to ensure effective deterrence.

In Summary

A predictable, competitive, and fair economic environment which is free of corruption is central to sustainable business, economic growth and national development. Going forward a number of players in corporate India would need to decide whether they will continue to rationalize corruption & fraud as a way of doing business or whether they will adopt more sustainable business practices. They would also need to decide whether to continue playing the 'victim' and blame the system, society and history of their problems or whether they will take the bull by the horns and lead a transformational change. Unless fundamental changes are made in tackling corruption and improving governance, the very basis of modern life would be under grave threat. Mass movements are the latest indicators of public disaffection.

Civil society should also work in a collaborative approach with the government and business to create a more transparent, true and fair system rather than an approach of confrontation. A rabid anti-corruption and anti-fraud stance can easily become an anti-government stance which can lead to anarchy. Or it may degenerate into an anti-business stance which can lead to slower economic growth. If peace and prosperity of a nation are hit, it can in the final assessment only hurt the poor and vulnerable sections the society.

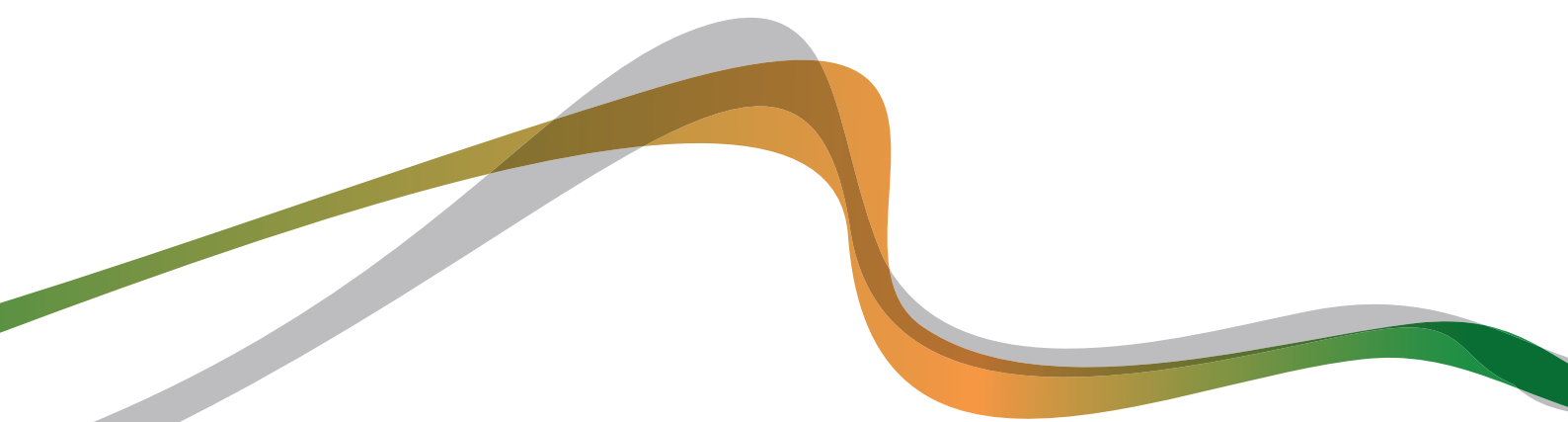
While, there cannot be a single silver bullet solution to curb corporate fraud and corruption, the current study is an attempt to look at the evidence available and compile the various facts and nuances surrounding this complex issue. It is an attempt to move away from the emotive appeal of the anti-corruption and anti-fraud stand to explore the subject dispassionately so that a platform of dialogue and possible solutions can be created.

It is hoped that the discussions and dialogue generated by the report could lead to a number of complementary and supplementary measures required both inside an organization and outside. A mix of regulatory and enforcement solutions and initiatives can very quickly move the current mind-set of gloom and doom to an environment which is suitable for more transparent and sustainable business. The high confidence thus created in business and society would help invigorate economic growth and development of society at large.

ENDNOTES

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