Financial Fraud—White Collar Crime and Punishment

The preponderance of the white collar crime over the street crimes has made the subject more meaningful for discussions today. Criminologists are of the opinion that the injury of white collar crime is not less than street crime in the number of persons affected in the society. The class and character of these criminals are different from those of street criminals and the judiciary is influenced by them. This paper attempts to advocate for the more rigorous punishment of these elite criminals to deter *recidivism*. It also tried to take stock of legal provisions for this purpose and the existing punishment policies to tackle this exploding problem. Though it is difficult to estimate the actual loss caused due to such crime, the paper also throws light on other methods to investigate the existence of financial irregularities in direct and indirect ways. Lastly, the paper listed some suggestions for curbing these increasing crimes in the financial sector.

Radhanath Pyne

(The author is Head of the Department of Commerce at the S. A. Jaipuria College in Kolkata.)

Genesis of White-Collar Crime

A deviant culture was observed in the thirties due to social fractures and ethico-moral crisis, which was normally witnessed among the people at the lower base[1]. But in his presidential address to the American Sociological Society in 1939, Edwin H. Sutherland related crime with high social status, occupation and differential association. He later defined the white-collar crime as a *crime committed by a person of respectability and high social status in the course of his occupation*[2]. In his paper published in the American Sociological Review in 1940, he talked about the trust violated by the respected white-collar class. A lot of confusion rose whether such activities could be designated as crime as it was not defined in the penal provisions. Questions were raised regarding

[1] *Reid, S.T: Crime and Criminology. 1982.*
[2] *Sutherland, Edwin H.: White Collar Crime. 1959.*

the responsibility shared between an individual and a corporate as an entity. Reasons for such activities have several explanations. White-collar crime has many aspects. Selling medicine beyond expiry date and adulterated baby foods in open markets are categorised under the white-collar crime type. Even allowing workers to work in a hazardous environment has also been specified as a white-collar crime. The scope of the present study limits itself to financial crime.

White and Blue-Collar Crimes

There are some basic differences between white-collar crime and street crimes, i.e. *blue-collar* crimes that are more violent and physical-force oriented. Street crimes require obvious intervention of the police. Cases of street crime are sudden and accidental in nature, and on many occasions, the losses are irreparable. They originated generally from lower classes, possibly without any defined occupational base. However, on the contrary, white-collar crimes are less violent and executed without a physical force. But they have a colossal injury to some particular class of a society, while having direct or indirect incidence on the people who believe in others. They benefit the offender or the corporate as a whole. Occupational opportunity helps to generate white-collar crime on many occasions. It is difficult to measure the actual loss in a white-collar crime and there is a negligible chance to make it to the news if it is not a huge one.

Though fraud, corruption and white collar crime are used interchangeably, they are not exactly the same. Fraud means a deception and willful neglect to draw interest out of an asset, whereas corruption is the untrustworthiness of an authority. Corruption may originate from a social institution. It might be an organisational combination of procedural and schematic corruptions. White-collar crime is more generic in nature. The World Bank aggregates global fraud to over one trillion USD per annum.

CIMA: Survey of Fraud in India, 2010

37 per cent	Paid as bribery to get routine administration approvals from government agencies.
31 per cent	Paid to win or retain business.
22 per cent	Paid to influence people to delivery favourable treatment.
10 per cent	Paid to use unauthorised resources.

Cost of white-collar crime is roughly assessed[3] . Among the small numbers of white-collar crime reported, uniformity has not been followed to measure the loss. When a loss is identified specifically with a crime, it is called a direct cost. There are certain indirect costs too of a white-collar crime, e.g. increase of taxation, higher insurance rates and increased costs of goods, and if there is any personal injury or a loss of life, it is known as physical cost of a crime. There are other social costs too, e.g. loss of trusts. Alienation from the masses can be another type of costs.

Among the small numbers of white-collar crime reported, uniformity has not been followed to measure the loss. When a loss is identified specifically with a crime, it is called a direct cost. There are certain indirect costs too of a white-collar crime, e.g. increase of taxation, higher insurance rates and increased costs of goods, and if there is any personal injury or a loss of life, it is known as physical cost of a crime.

A recent survey on fraud in India says that 74 % of the respondents strongly perceive IT fraud as a serious risk for organisation and less than half, i.e., 46 %, of the respondents are aware of fraud prevention and detection tools. Though the whistle-blowing activities are one of the dependable factors in detecting and preventing fraud, it is known that their protection is not enough. It has been suggested that the monetary reward plays a positive incentive for whistleblowing[4].

Manipulation techniques: Some common methods of cooking the books are:

(a) *Earnings management* (intentional manipulation of company's revenues and expenses through the use of accruals or reserve accounts): Swapping some current revenues and expenses with future and forming some reserves like reserves for litigation, bad debts, returned products and environmental remediation which are totally based on estimation where the GAAP is vague. Accounting for reserves known in the accounting literature as *loss contingencies* is highly estimable and, thus, easily manipulated. In June 2002, it was found that Microsoft Corporation recorded and adjusted its reserve accounts in ways not permitted by GAAP in its quarterly and annual filings.

(b) *Cherry-picking* (a method to record one time gain to boost the income and failing to disclose all liabilities): It generates the concept of *Structured*

[3] *Shenk, J.F & P.A Klause: The Economic Cost of Crime to Victims. 1984.*

[4] *Dyck.A, Adair Morse & Luigi Zingales: Who Blows the Whistle on Corporate Fraud. From The Journal of Finance, 65(6), 2010.*

Finance devices sold to the clients by the Wall Street, e.g. synthetic leases, special purposes entities and unconsolidated subsidiaries. These techniques are used in the companies where capital is heavily required. For spreading the risk, they also use derivatives like options, futures, swaps, etc. Limited partnerships are extremely used to avoid tax. Mainly, energy, gas and oil companies found the pleasure to use this structured finance. Having 2500 subsidiaries, Enron siphoned their debts and losses to unconsolidated subsidiaries, and gains and income to consolidated subsidiaries. It used mark-to-mark accounting to generate income in the consolidated part where losses to its merchant investment portfolios. So, the financial statements of Enron showed a part picture and this is the essence of cherry-picking strategy, which is also a selective disclosure of bank loans. Guarantee of repurchasing of receivables with a use of factoring by other companies should be properly disclosed as loan in the balance sheet instead erasing the receivables and increasing the cash flow. Basically, cherry-picking emphasizes on form over substance interestingly, which is accepted by the auditors with an aggressive interpretation of the GAAP.

(c) *Channel stuffing* (a practice of pushing inventory into the channel, which generally consists of a network distributors or sellers): Normally, it is not fraudulent. A new product should be piled up in the shelves of the distributors but if such stocking of goods in the channel inflate the revenues of the organisation, it is fraudulent. Recording consignment sale as a sale is another kinds of fraud in channel stuffing. GAAP prohibits recognition of revenue when it is transferred from seller to reseller as sale. In other words, the consignment sale is considered as contingent on resale. Another example is a right to bill back the seller for unsold goods. Sometimes, a customer-reseller nexus can create false sale which is difficult to be checked by the auditors. Fraudulent confirmation of sale creates false receivable which remains uncollected and make auditors skeptical about the revenue generation.

Recording consignment sale as a sale is another kinds of fraud in channel stuffing. GAAP prohibits recognition of revenue when it is transferred from seller to reseller as sale. In other words, the consignment sale is considered as contingent on resale.

(d) *Topsiders* (most common type of fraud where the unsupported entries are booked and lot of operating expenses are capitalised to prove a loss company profitable): In June 2002, a civil complaint was filed against the WorldCom to capitalise billions of dollars.

The above methods are the broad policies through which the financial fraud is committed. Apart from those, some common specific adjustments which came to the surface through investigation are:

(A) Making illegal payments as transfers: An offender may take hidden interests in related transaction to earn fraudulent profits. There are certain traditional methods of making and concealing illegal payments:

(a) *Corrupt gifts:* Gifts with corrupt intent, from a box of cigar to houses, provide an easy and safe way to initiate a corrupt relationship.

(b) *Cash payments:* Payment of cash is the most favoured method of making corrupt payments. When paid in small amount, it is difficult to trace.

(c) *Cheques and other financial instruments:* Where large amounts of cash are difficult to conceal, payments are made through regular business cheques and, sometimes, through intermediaries.

(d) *Hidden interest:* As per the mutually accepted plan, a payer and a recipient may invest the illegal funds to a joint-venture business where the interest of a recipient is concealed through nominee hidden in a trust or undocumented verbal agreement.

(e) *Fictitious loans:* There may be three types of loans which attract fraud, i.e. first, an outright payment described as a loan, second, when a recipient receives a loan through an illicit payer guaranteeing or making the payments and, third, where a type loan is payable to a recipient under favourable circumstances like interest free or with other corrupt intent.

(f) *Transfers at other than fair-market value:* Corrupt intent is clear where the property is transferred at lower than market price or at an inflated price. Another variation of this technique is phantom sale, where there is a sale but the payer retains the control to use the property.

(g) *Promise of subsequent employment and payments:* Another corrupt payment is for the payer to promise the intended recipient a lucrative employment or

giving an inflated retiring or separation benefits.

(h) *Floating:* Floating is a kind of embezzlement where a day's receipt is substituted by the following day to tally the accounts. In net, deposits are late by a day.

(i) *Lapping:* Lapping is the substitution of cheques for cash received in a business. So, the advantage is reaped between receipts and deposits of the business.

(j) *Cooking:* Lapping is the substitution of cheques for cash received in a business. So, the advantage is reaped between receipts and deposits of the business.

(B) Concealing illegal payments and transfers

(a) *On-book schemes:* On-book schemes occur only after the receipt of funds in question. Illicit funds are drawn on a regular basis in the disguise of a legitimate payment from a regular bank account as travel or entertainment expenses. As the withdrawal is not large, such manipulation protects the payer. Though such payment leaves audit trail and it sometime needs a third cooperative party through which such so-called legitimate expenses are made.

(b) *Off-book schemes:* When the funds do not come from regular sources and do not appear in the accounts and records, it is known as off-book adjustments. Small amount of illicit payment can be made from the payer's pocket, but, for any large payment, it is collected from unrecorded sales. This method is very popular in cases of large amount cash sale. Major advantage of this scheme is secrecy and major disadvantage is to generate a large amount of off-books funds.

C) Trail of illicit transfers: There are only two ways to trace the illicit transfers:

(a) *From the point of payment:* There are three categories of on-book payment schemes—fictitious payables, payment to ghost employees and overbilling schemes. Fictitious payables include payment of kickbacks, payment for services, sales commissions, consulting fees, endorsement of cheques are some of the points to emphasise. Absence of documentation or backups, use of photocopies and its alteration, unnumbered or sequentially numbered are the vulnerable points. Fictitious salary payment to non-existent or former employees or making extra payments to current employees are common facts of illegal transfers. These amounts are returned to a payer or passed to a corrupt recipient. Detailed checking of payroll accounts along with supporting documents helps in preventing such activities. Overbilling means paying excess amount for goods and services distributed; excess payment is returned to a payer by a distributor. This process is more secretive than that of giving excess rebate by a corrupt payer. Off-book payment is difficult to trace than on book schemes. It is traced through the indirect evidence of unrecorded sales from the books and records. Unbalanced ratios between cost and sales help to detect such off-book payments.

(b) *From the point of receipt:* Direct or indirect approach may be adopted to investigate a receipt of cash. Direct approach relies on specific transaction such as sales receipt, and indirect approach relies on evidential proof of the income of a recipient by using such methods as net-worth analysis. Net-worth analysis is discussed below as it is commonly used:

Assets	XXXXX
Less liabilities	XXX
Equals Net worth	XXXXX
Less prior year's net worth	XXXX
Equals Net worth increase	XXXXX
Plus living expenses	XXXX
Equals income	XXXXX
Less funds from known sources	XXXX
Equals funds from unknown or illicit sources	XXXXX

Living expenses are neither assets nor liabilities. They include, but limited to, household expenses, food, auto repairs, insurance premium medical expenses, personal tax, entertainment expenses and gifts. Other than net-worth analysis, bank deposit calculation can also give an indication of receiving illicit money. It is calculated as:

Total deposits to all accounts	XXXXX
Less: Transfer and redeposits	XXXX
Plus: cash expenditures	XXX
Equals: Total receipts from all sources	XXXX
Less: Receipts from known sources	XXXX
Equals: Funds from illicit or unknown sources	XXXXX

Legal Protections

Some scattered and reactionary enactment of legal provisions proves too weak to handle these accounting chicaneries; still, it will be interesting to watch legal

On-book schemes occur only after the receipt of funds in question. Illicit funds are drawn on a regular basis in the disguise of a legitimate payment from a regular bank account as travel or entertainment expenses. As the withdrawal is not large, such manipulation protects the payer.

protection developed in some countries. In the USA in 1934, the Congress established the *Securities Exchange Commission* (SEC) to be an economic watchdog. By the 2000s, the SEC grew into a full enforcement agency with the help of the Congress. But statistics says that 48 % of the cases that were recommended for prosecution by the SEC, were not prosecuted. The agency is notoriously understaffed with limited resources. They are also criticised for being too lenient against security violation.

Racketeer Influenced Corrupt Organisation (RICO) Act was established by the Title IX of the Organised Crime Control Act, 1970 to provide enhanced criminal penalties and establish a new civil cause of action for the acts performed in an ongoing criminal organisation. This enhanced sanction punishment was enacted to control the unlawful activities. *Racketeering* is defined under the statute as *any act or threat involving murder, kidnapping, gambling, arson, robbery, bribery, extortion or dealing in narcotics or other dangerous drugs which are chargeable under the state laws*. RICO also allows the government to seize any property that it believes as acquired from or purchased by illegal activities. The most notable white-collar prosecution under the RICO involves an insider trader, who tried to manipulate stock and bond racketeering and fraud.

In 2002, the Congress passed the *Sarbanes Oxley* (SOX) Act of 2002 in response to large corporate scandals evolving Enron, Tyco International, Adelphia and Worldcom. The SOX Act established the *Public Company Accounting Oversight Board* (PCAOB) which is responsible for oversight, regulation and discipline in accounting firms while auditing public companies. The Act does not apply to private companies, while making CEOs personally liable, civil and criminal for any misrepresentation on those statements. It also increases the quantum of penalties. Primarily Section 308 of the SOX Act is laid down to compensate the victims. It was inserted basically to prepare a fund for the Enron losers. Many argue that the cost of compliance with the SOX Act is very high. In 2007, a survey of one hundred sixty eighty companies averaging revenues of $4.7 billion, the average cost of compliance was $1.7 million. It is realised that SOX has a negative impact on US companies as after enactment the rate of US companies deregistration from US stock exchange tripled. In 2007, Parliament passed the *Serious Crimes Act* (SCA) which established *Serious Crimes Prevention Orders* (SCPOs). This has the potential to prevent white collar crime.

In 2006, the United Kingdom built the *Serious Organised Crime Agency* (SOCA) to reduce the criminal activities. A number of agencies were formed as the taskforce agencies, two of them are—i) *Serious Fraud Office* and ii) *Financial Services Authority* (FSA) to monitor the commercial crimes. With those agencies, the parliament created SCPOs as a preemptive step in white-collar crime enforcement. The SCPOs cover people who are directly or indirectly involved in serious crimes irrespective of their willfulness. The first SCPO orders were issued by the Isleworth Crown Court on 27th June 2008 in response to an investigation concluded by SOCA. The above mentioned FSA, a non-governmental independent agency was established by the Financial Services and Markets Act, 2000 is considered as the world's first *unified financial service regulators* and operates with the budget of 270 million pounds and supported by 2,800 staff. At present, the FSA regulates 29,000 in the UK and published a rule book over 8,000 pages for all authorised business operating in UK.

The difference in approaches between two countries regarding white-collar crime is that the US relies on harsher punishment and larger fines to deter it, whereas the UK approach is to develop a better preventive system to deter the white-collar crime. But the above two approaches are not hundred percent perfect. The implementation of the laid acts in a right manner whether it is the SCPO in UK or RICO and SOX in USA will be the right move to the right direction. In India, the legal environment set to combat the white-collar crime is adequate but it is not effective due to its lenient implementation. There are the *Indian Penal Code of 1860, Prevention of Corruption Act, 1988, Benami Transactions (Prohibition) Act, 1988 and Prevention of Money Laundering Act, 2002*, which penalise the people involved in financial frauds.

Besides the above mentioned Acts, other major regulatory changes implemented in India to combat fraud and corruption were *Right to Information Act, 2005* and *Companies Act, 2013*. Another law, the

Foreign Contribution Regulation Act was enacted in 2011, but that has very limited scope of tracing the ultimate use of funds received from abroad. *Lokpal Bill* and *Prevention of Money Laundering Bill, 2011* are other ongoing steps to curb corruption in India.

Regulations in India have changed a lot to fight against corruption, especially the financial corruption. *Public Interest Disclosures (Protection of Informers) Bill, 2010* (dealing with disclosures of information in public interest where private sector is excluded and investigation is not time-bound), *Prevention of Corruption Amendment Act, 2011* and *Prevention of Bribery of Foreign Public Officials* (FPO) and *Official of Public International Organisation* (OPIO) *Bill, 2010. Serious Fraud Investigation Office* (SFIO) has the power to probe companies suspected of fraud and SFIO's report is equivalent to police report with a power to arrest with the help of CBI. On the other side, the *Data Privacy Laws* of Ministry of Communication and Technology protect personal and financial information. In the periphery, the *Competition Act* for anti competition arrangement, abuse of dominant position with the regulation of combination was laid down to set the ambience of doing business ethically.

Apart from the regulations stated above, a white-collar criminal is punished basically with the ways followed as in the philosophy of punishment. Those are retribution, incapacitation, deterrence, rehabilitation and restoration. Retribution is the punishment judged on the principles of revenge where the judgement is based on the idea of *eye for an eye*. Principle of incapacitation tries to decrease the capacity of the offender to commit crime in future with the help of detention and it is also the objective of the confinement by which a criminal may not return to the community with same status. Deterrence judges the mismatch between sanction and behaviour of an offender. Method is soft in nature as those sanctions vary according to social, ethical and religious beliefs of different societies. Rehabilitation is a method by which an offender is restored to the community after converting their spirit at the time of confinement to bar them from reoffending. Restorative justice is a method applied to offenders where they and their community are integrated and institutionalised. Now the important question is, if white-collar criminals are justifiably punished or not based on this philosophy.

In the USA in 1934, the Congress established the Securities Exchange Commission (SEC) to be an economic watchdog. By the 2000s, the SEC grew into a full enforcement agency with the help of the Congress. But statistics says that 48 % of the cases that were recommended for prosecution by the SEC, were not prosecuted. The agency is notoriously understaffed with limited resources.

Cases and Conviction

The reality does not encourage the understanding we get from the theoretical perspective. Right from the pre-Second World War periods till today, the white collar criminals are punished in a low tune. Though the punishment philosophy has changed from retributive to consequential approach of neither from the two a proportional punishment has achieved for the white collar criminals. The average time convicted white collar criminal served is about 16 months. Basically, the criminal liability of a corporation for the action of its employees (e.g. manager, executives or agents) has evolved on the theories of the imputation and identification. The imputation theory holds that the firm by imputation liable for the intent and acts of its employees. The identification theories proposes that the firm's liability is direct when "agents" identified with the firm are acting on its behalf. But such identification is rested on the auditors who are paid handsomely for consulting than investigation like for every dollar of audit $2.69 is paid for consulting. Now it should be mandatory to separate auditing with consulting. In India, the ICAI has taken up the cases of professional misconduct acting quite efficiently, stringently and rigorously, as per the provisions specified in the first and second schedules of the Chartered Accountants Act, 1949. Of late, it has concluded a number of cases through its Disciplinary Committee, **which has one presiding officer (usually the President of ICAI) with two members nominated from its Central Council and other two nominated by the Central Government.**

At the top level too, the board is not free from bias to take some unethical decisions depending on the balance of interest. In 1989, Colgate form their board staffed entirely by outside independent directors. Among the 200 companies performance measured by Business Week, Colgate ranked top 10 among the US Boards. General Electric added three independent directors to replace two inside directors. But the performance of the board is not always satisfactory because in US about 40 % of the large corporation conduct formal evaluation of the performance of their boards.

In 2006, the United Kingdom built the Serious Organised Crime Agency (SOCA) to reduce the criminal activities. A number of agencies were formed as the taskforce agencies, two of them are— i) Serious Fraud Office and ii) Financial Services Authority (FSA) to monitor the commercial crimes.

After Sarbanes Oxley Act of 2002, some activities like omission of material information, failure to sign an SEC disclosure have included in the definition of fraud which was considered mere a civil liability before and penalty was awarded according to that. The conversion from one liability to others also requires standardisation of punishment. The best way to standardise punishment would be to increase the perceived reasonableness of recommended sentences. Section 906 and Section II presents a brief description of the acts criminal provisions which are meant to cultural mis-statements in Corporate Accounting Reports. Section III deals with a framework under which Congress should justify white collar crime statutes using the theories of punishment. The Act bans loans to corporate officers and increases the regulation of auditors extending civil remedies that plaintiff can use against corporate officers who violate the statute. The corporate officers cannot claim the defense of ignorance and the willful negligence will cost $ one million or 10 years imprisonment or both [Section 906(a)]. If an officer signs a document knowing that it does not conform to the SEC Act of 1934 will receive penalties upto 20 years in prison of $ five million or both. These monetary fines have two related problems which defies the retributive or utilitarian justification. First the inflationary problem and second the fines are not calculated basing on the wealth of the most likely offenders. The limit set one time and not revised often cannot work as deterrence to the future. The fixed amount of a typed crime today may be valued less in future in similar type of crime. In the corporate yardstick too, this fine will not improve the corporate culture as the amount is not that much. The fines will be determined based on the income and wealth of the offender.

The other mode of punishment is incarceration which is supplemental and which will affect the white collar crime and the street crime equally. But in incarceration too there are three general problems, firstly, the period will be less than the street crime, secondly, criminal justice system is not always

applied to white collar crime and lastly there is a strong argument that white collar criminals are sent to minimum security prison. The probability of surfacing the white collar crime is also bleak as there is no protection of the whistleblowers or informants barring Section 1107 of the Sarbanes Oxley Act which again will not help them to get another job in future.

Conclusion

After judging several aspects of financial frauds as white-collar crime, it is realised that financial irregularities are growing out of proportion due to leniency in steps. There is a judicial gap between understanding and implementing the decisions to curb it. Accounting gatekeepers in the financial arena are also not playing an ethical role to reduce the damage coming out of such crimes. White-collar crimes are not less damaging than street crimes. Though there is a difficulty of calculating the actual loss, the proportional punishment for a crime is hardly applied. In India, financial irregularities are huge in public-sector and hardly one or two have made news in corporate sector due to their magnanimity. It is also true that elite criminals influence the judiciary and prosecution system with their social and financial positions. Philosophy of punishment is also changing from the retributive to a liberal one. Execution of steeper punishment is necessary for deterrence. And introducing more oversight bodies will be more effective to control such irregularities as there is a feeble chance of getting more whistleblowers who are less protected by the society. It also requires a social consciousness to assess the loss of affected community and consider white-collar criminals as harmful, if not more, equally like street criminals. Advanced knowledge of technology is required to investigate accounting manipulations and forensic audits because majority of the respondents in the fraud study has the opinion that digital manipulation has fuelled the financial shenanigans.■