

# Business fraud causes, detection and solutions



## INTRODUCTION

In the early phase preceding the subprime mortgage crisis, the assumption was made that home prices would only go up. Coupled with too much borrowing and flawed financial modelling, this caused borrowers to get into high-risk mortgages. These borrowers qualified for mortgages with little documentation and even individuals with bad credit could qualify as subprime borrowers (no income, no jobs, no assets). The consequences of this crisis were considerable: from the wrongful foreclosures of American housings, the devaluation of investments to a complete loss of shareholders' trust[1]. However, the main big financial institutions, and especially Wall Street, have not yet been held accountable for their wrongdoings. No real criminal prosecutions were in fact made but for two exceptions to date concerning low-echelon employees of these financial institutions.[2]

This review assesses the different causes of fraud and presents models built by researchers to help detecting fraud in a first part. In a second part, it analyses the complex nature of the financial system and provides insights on the difficulty to identify a unique, single culprit in the financial sector. Finally, the third part of this review presents potential remedies to avoid fraudulent activities.

### Part 1: Assessment of corporate failure and fraud

This first part addresses the fundamental causes of fraudulent activities and presents the models of detecting fraud. According to Black's Law Dictionary, fraud consists of “ *deceitful practice or wilful device, resorted to with intent to deprive another of his right, or in some manner to do him and injury. As*

*distinguished from negligence, it is always positive, intentional*" [3]. Not only is fraud deceitful in nature, but is also the source of instability in competitive financial markets[4].

### 1. Causes

When researchers examine the possible causes of disruptive behaviours, they all confirm an evident breakdown of social norms, leading to an increase of criminal activities in financial organisations. Researches conducted by Bahram Soltani (2007) helps identifying six main areas, where unethical behaviours arise eventually. The first area describes managerial misconduct in a corporate ethical climate. Bazerman and Tenbrunsel (2011) [5]describe this phenomenon as a "*bounded ethicality*" referring to the existence of blind spots individuals use to differentiate themselves from a broader social context. Corporate misconducts should not be limited to the responsibility of single individuals, but rather that the organisation should be held accountable for their misbehaviours. The Ethical Climate Theory endeavours to explain managers' wrongs and the relevant measures of actions that should be undertaken to identify motives, attitudes and rationalisation of employers when fraud is present in the organisation.

The second area, particularly relevant to Soltani, is the way executives and managers lead their organisation. John Bogle (2005) argues that there is a new type of capitalism in our societies: the "*managerial capitalism*" [6]. According to him, there is a link between managerial capitalism and the decline or even the loss of ethical convictions and behaviours in business-like practices. Environmental factors such as Bubble Economy and Market Pressure constitute another possible area of unethical blind spots for fraud.

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Two areas of concerns relate to, on one part, the accountability, control mechanisms, internal auditing, and corporate governance and, on a second part, to the personal interest of the organisation, seen as perceived incentives for fraud. With the recent financial crisis, there has been a huge expectation gap between the management of the firm and their investors. There is an obvious lack of internal control that need to be supervised. Wall Street and other corresponding financial institutions virtually possess the perfect set up for criminogenic environment. For example, the major Credit Rating Agencies such as Moody's, Fitch and the Standard & Poor's are given little regulation, mostly because of their importance (Mayer, D., Cava, A., & Baird, C., 2014)[7].

#### b. Detecting Fraud

This part presents models proposed by different authors to detect fraudulent activities. Financial Fraud leads to important financial losses for a firm and undermines investors' trust towards the institution. Kirkos et al. (2007) [8]stresses three main reasons why it is difficult to detect fraudulent activities: lack of knowledge about fraud, lack of expertise, and finally the corporate executives deliberately hide potential tools to detect fraud.

The first model is called the Fraud Triangle Framework , which is an integral component of ISA 240 of IFAC, SAS 99, and PCAOB-AU Section 316. 6 (or, the Classical Fraud Theory), describes three main conditions for fraud to take place (Soltani, 2014). The first element is *incentive* , which describes the reasons of committing fraud, includes excessive pressure. The second element relates to *opportunity* , which constitutes the available blind spots

for management to overturn internal and external financial reporting controls. The last condition explores the *attitudes*, or the set of characteristics, that allow individuals to act dishonestly.

However, many researchers have criticised the ability of the Triangular Framework to deter and prevent fraud, because of its narrow approach. By assessing fraud solely on these three conditions is the perfect lay out for fraud to happen again. In addition, researchers have also observed that not all fraudulent activities fall in these categories: *"...All the predator seeks is an opportunity. The predator requires no pressure and needs no rationalization"* (Dorminey et al. 2010, pp. 20-21)[9].

They have been several models already established over the past two decades and more to detect fraud at its core. However, the model that brings the highest accuracy and reliability in terms of fraud is the Financial Fraud Detection Model based on the Random Forest test. This model is built on the previous models of Hansen (1996) and Kirkos et al. (2007) with three sections: The Decision Tree (DT), Neural Networks (NN), and the Bayesian Network (BBN). Among these three approaches, results showed that the BBN has the highest accuracy in predicting fraudulent practices. Abbott and Parker (2000) also look at the relationship between auditors' meetings with corporate executives. It shows that these two variables are good indicators for the interpretation and regression of fraud.

## Part 2: Accountability of individuals vs. system?

The purpose of this section is to understand whether holding some individuals accountable for their misconducts would solve the issue of fraud

or if the problem is the simple result of long-lasting flaws in the system.

Moreover, it is important to understand why prosecutions of wrongdoers are so hard to make.

### 1. Accountability

Even up to now, the financial crisis still shows that the risk undertaken by some large institution undermine the whole financial system: the influence of strong neoliberal interests and ideas compromises the awareness of systemic risks. This issue seems to follow a predicted cycle referred to as the Cyclical or Polanyian model. The model argues that the financial crisis was the results of years of market-friendly regulation to very restrictive forms of regulations, which led to the current post crisis meltdown. (Block, 2011; Streeck, 2012). The authors endeavours to show that elites are not self-centred and governed by corruptive incentives; but rather that they have a strong incentive to maintain stability. Foucault's late work shows that neoliberalism brings uncertainty at the heart of governance practices.

The concept of normalisation puts forwards two important aspects: uncertainty seen as a component of norms and order, rather than as an external limit to knowledge (Kessler, 2009)[10]. Thus, speculation involves reputation and impression management. The second aspect is the hierarchisation of norms is an on-going process. Banks never eradicate uncertainty because they add new sources of risks. According to Minsky, CBs do not represent an external form of regulations but that is itself banking and subject to similar logic of normalisations. Systematic risk is to deny "the too big to fail" logic as an integral part of neoliberal governance.

## 2. Difficult Implementations of Prosecutions

It is often seen as hard to make individuals held accountable in the court of law and prosecutes the big financial institutions responsible for lying to the public.

The structure of financial institutions and the way they operate are complex in nature. Another important aspect is that the justice system purposely see these misconducts as real crimes. The next factor refers to the “ *regulatory capture* “[11], which implies that the regulation somehow favours the regulated. Under investigations, regulations protecting potential wrongdoers are too difficult to counteract. Budget limitations constitute another potential reason for making prosecutions harder to be conducted. Moreover, financial markets are assumed to be self-regulated and efficient. This assumption reduces the level of commitment or willingness to punish fraudulent activities in these markets.

Finally, financial institutions are given high levels of political protection and support, mainly due to their dominant involvement in political matters.

## Part 3: Solutions to Fraudulent activities in the Financial Sector

This part presents alternative models, laws and statutes that have been established to control and prevent fraudulent practices for happening.

### 1. Global Business Integrity model

The Global Business Integrity model is an alternative framework balancing conflicts of interests between morality, human nature and capitalism.

[12]This model attempts to provide a viable solution to stop the vicious

cycles of instability and fraudulent practices in the financial sector. It is based on human science theory of morality and on four different quadrants: the community capitalism, the entrepreneurial capitalism, the regulatory capitalism and the investor capitalism (Petrick, 2009). Business integrity capacity is defined as the “ *aggregate individual and collective capability for repeated process alignment of economic, psycho-social, and moral awareness, deliberation, character.*”[13]However, this model requires a new level of business integrity that financial institutions are willing to offer. Credit policy judgments will fail to prevail if one or more of these quadrants are over- or underemphasised.

## 2. Laws

There are virtually two ways to fight fraud in the financial sector: the mail or wire fraud, or securities fraud regulations.[14]The mail and wire fraud statutes are both widely used by the prosecution to prove that fraud is committed. The only difference between these two statutes is the means of transmitting/expressing fraudulent activities. This is probably one of the main federal government’s weapon to fight fraud, but is difficult to prove that fraud activities are operated just with these laws.

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[1]Pontell, H., Black, W., Geis, G. (2014). ' Too big to fail, too powerful to jail? On the absence of criminal prosecutions after the 2008 financial meltdown', *Crime Law Soc Change* , Vol (61), 1-13

[2]The two exceptions were with Kareem Serageldin (Former Managing Director of Credit Suisse Group AG) who pled guilty to conspiracy in 2013 and was sentenced to 2 ½ years in prison for inflating the value of mortgage bonds while the housing market was collapsing. The second exception was Lorraine Brown, CEO of LPS (subsidiary of DocX, Wall Street banks). She pleaded guilty to mail and wire fraud for robo-signing and incurred 5 years in prison for role in mortgage-related document fraud scheme.

[3]Mayer, D., Cava, A., & Baird, C. (2014). ' Crime and Punishment (or the Lack Thereof) for Financial Fraud in the Subprime Mortgage Meltdown: Reasons and Remedies for Legal and Ethical Lapses', *American Business Law Journal* , Vol (51), 515-597

[4]Former Federal Reserve Alan Greenspan commented on fraudulent practices in 2010 " *Fraud, fraud is a fact. Fraud creates very considerable instability in competitive markets. If you cannot trust your counterparties, it won't work. And indeed, we saw that it didn't.* "

[5]Mayer, D., Cava, A., & Baird, C. (2014). ' Crime and Punishment (or the Lack Thereof) for Financial Fraud in the Subprime Mortgage Meltdown: Reasons and Remedies for Legal and Ethical Lapses', *American Business Law Journal* , Vol (51), 515-597

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[11]Professor W. K. Black stated that " *regulators and prosecutors have defined out of existence accounting control fraud- the leading cause of financial losses and crises .*" (2012)

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