

## Corporate investigations

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### Abstract (Summary)

The aim of the research is to explain the requirements for conducting a corporate investigation and to indicate that corporations must have effective corporate governance and compliance structures that are flexible and innovative to combat new and emerging frauds. The methodology is to give a brief overview of the major past and current frauds, explain the nature of corporate crime and how a corporation should go about conducting an effective corporate investigation. The paper gives some warnings about new and emerging frauds and emphasises lessons to be learned from large corporate failures, such as Enron and Parmalat. If corporations are not vigilant and do not have innovative and adequate corporate compliance structures, they open themselves to weaknesses that can effectively cause their own demise. The paper gives direction on how to conduct an effective corporate investigation and the relevant steps that should be considered if an investigation is undertaken. It also provides practical oversight of conducting financial crime investigations and a warning to corporations and their advisors to be vigilant and ensure that there are appropriate corporate compliance structures in place to deal with emerging frauds or other financial crime.

### Full Text (9684 words)

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#### 1. Introduction

I keep six serving honest men, they taught me all I knew. Their names are what and why and when and how and where and who (Rudyard Kipling, 1865-1936).

This paper on corporate investigations emphasizes the need for corporations and those who serve them to be vigilant, conscientious and innovative in operating compliance programs to combat corporate fraud. Corporations now and in the future will have to review audit and compliance procedures frequently and have the capacity to conduct internal investigations in a timely manner where fraud has occurred.

Corporate fraud investigations into individuals and corporations by enforcement agencies, statutory regulators and internal companies committees have increased in intensity over the past few years. However, most of the large investigations by regulators have occurred long after the corporate horse has bolted ([11], [12] *Financial Times*, 2006a, b; [5] *Complinet News Story*, 2006; [1], [2], [3] AFR, 2002a, b, c).

Fraud crosses all professional fields, from executives, lawyers, accountants, politicians and academics ([13], [14] *Financial Times*, 2006c, d). The most recent PWC survey on global economic crime shows that 45 per cent of companies worldwide have fallen victim to economic crime in the past two years [1].

Over one third of corporate frauds were discovered by accident, "making 'chance' the most common fraud detection tool"[1]. We have to ask ourselves two questions, "How much have we learnt about dealing with economic crime and do corporations have effective structures in place to detect economic crime?"

These revelations, despite the intensity of press reports, are not new. Profits of large international corporations have been shown to be fictitious[2]. Recent surveys in e-commerce businesses indicate that executives, in many instances, are misinformed about the vulnerabilities of their network systems[3]. In particular, accounting fraud has attracted the most recent attention simply because of the billions of dollars involved. It shook the confidence of investors and financial institutions in the world markets. We only have

to look at the recent revelations of the Enron court proceedings which reveal allegations of purposeful “cooking of the books’ and charges of conspiracy, fraud and insider dealing which has caused the second largest bankruptcy in US history[4].

The corporate fraud train has been gathering momentum for some time, particularly in the USA, Europe, China, Japan and Australia. The historical stations are somewhat repetitive. From the South Sea Bubble in 1720, to the Pecora investigation into market manipulation in the USA in 1933 ([9] Pecora, 1939), to the corporate collapses in the 1980's, to the current day large fictitious frauds bringing down conglomerate corporate giants in this millennium. They are all landmarks that forerun countless government papers and investigations into corporate crime. Although the expression “white collar crime” was coined more than 50 years ago by Edwin Sutherland and Donald Cressy[5], it has taken on a new meaning in 2006. The measurement of corporate fraud has arguably reached a different dimension. Auditors, business analysts, accounts, lawyers, bankers and company doctor's should be independent and working for the advantage of the body corporate. Instead, they have pleaded guilty to the most significant corporate frauds in legal history, eroding the very reputation of these professions.

### **1.1 No amount of legislation can protect against dishonesty**

The reality is that no amount of legislation can protect against dishonesty. Where there are no proper independent internal compliance and investigation procedures within the body corporate, the organization will be susceptible to fraud and manipulation by those that control it.

HIH;s, Enron, Worldcoms and Parmalat do not occur over night and it appears to be a mentality that frauds can be perpetrated and those involved feel that they cannot be caught. How has this mentality been brokered within the corporate arenas? We must be honest with ourselves and start to question; have we learnt anything? Are we doing anything realistic about it? Why have investors and directors been blindly bullish?

Today is, in many respects a continued evolution of corporate misfeasance. In 1932, Roosevelt, while campaigning for the presidential election spoke of “the ruthless manipulation of professional gamblers and the corporate system”[6].

It is very clear that fraud continues to be a prominent issue internationally and it is increasingly clear that many companies are still deficient in the corporate governance stakes.

No amount of regulation or endless legislative provisions can protect corporations or investors from dishonesty or misconduct. However, fraud can be reduced by a having a strong corporate governance culture that can prevent and deter fraud. Standards of ethics must come from within and be reflected in proper internal compliance.

Many companies worldwide have launched internal investigations and informed their boards of directors. Increasingly, companies are commissioning external investigators where fraud occurs. When there is a fraud within an organization – you have to ask the question, how do you effectively commence an internal investigation.

In this paper, I will set out and discuss, in non-legal terms, the ingredients of a corporate investigation. It is suggested that future corporations will evolve to a degree where there are independent audit and legal investigative teams. They will report only to “director committees” or “audit committees”. They will have obligations to be proactive and investigate and report all suspicious transactions or contraventions of the law within relevant timeframes. If we are to investigate corporate crime, we also have to understand what it is, how it evolves and how best it should be addressed.

## **2. What is white collar crime?**

Corporate crime or “white collar crime” can be broadly defined as: offences that are committed by those in professional occupations conducting dishonest activities, by themselves or their agents for financial gain.

Such crime is usually committed by persons in positions of trust or by persons within organizations who take advantage of their position. However, the dimension of crime extends to the activities or organizations being involved in illegal conduct. In the last decade corporate crime has been given new dimensions. The growth of information technology, environmental protection and increased regulation of corporations is making it a very complex area for directors and their advisors to keep abreast of the changes.

Corporate crime can be characterized as follows, crimes committed:

- against corporations by officers, directors and employees;
- against corporations by outsiders; and
- for corporations by internal forces ([19] Bologna and Shaw, 1997).

Corporate crime evades every aspect of modern living including, company dealings, securities markets, trade practices, environmental protection, occupational health and safety, employment and discrimination, immigration and taxation. These are overall areas that can interact with a consequence that corporate criminal offences can involve any one or more of these areas[7] ([17] Grabosky and Braithwaite, 1987).

Traditionally, corporations have relied on government agencies to conduct their investigations and prosecute white collar crime. However, in the next decade, law enforcement agencies will not have the capabilities to investigate all corporate crimes. There will be an increase in the role of private investigations to supplement some of the roles of enforcement agencies.

Further, recent corporate frauds intuitively tell us that large corporations may need investigative capabilities in-house to ward off a major collapse. If effective it will act as an insurance policy for their own survival. Companies have become increasingly complex and operate through international holding companies which have had the ability to confound some of the best audit firms that oversee them.

## **2.1 Dimensions of corporate crime**

The dimensions of corporate crime investigation are wide ranging and include:

- frauds – financial or otherwise;
- internal audit fraud and compliance breaches;
- securities contraventions, including non-disclosure to the public;
- bribery;
- insider dealing;
- market manipulation;
- corruption;
- taxation avoidance;
- trade practices and market conduct;
- insolvent trading;
- fictitious or false accounting;
- misleading financial statements;
- corporate governance, related party transactions and directors duties;
- prudential regulation;
- food standards;
- road and rail standards;

- economic offences against and by employees;
- discriminatory workplace and employment practices;
- environmental law contraventions; and
- occupational health and safety.

Corporate crimes usually occur initially where there are gaps in procedures. Individuals see weaknesses in the existing system and take advantage of an opportunity that is presented to them. David Coderre, in his work “fraud detection” explains that the reasons for committing fraud are understood by reference to a “fraud triangle” which allows opportunity, pressure and rationalization. The learned author explains:

The opportunity for fraud arises when controls are weak and/or when an individual is in a position of trust. While the pressures on those to commit fraud are often financial, unrealistic corporate targets can influence employees to commit fraud to meet targets. The rationalization for fraud often includes beliefs that the activity is not criminal, their actions are justified[8] ([17] Grabosky and Braithwaite, 1987).

In many instances, management in corporations are just not up to date on the different developing frauds. Often, corporations only act when they are awoken to the fraud. It is important for directors and management to constantly review internal procedures. They should introduce fraud awareness programs and update risk management requirements. There is growing support for the approach that pressures for logistical reasons for companies to launch investigations into corporate crime, to determine contraventions of the law or ethical standards ([22] Darvall-Stevens, 2002).

Directors should also keep away from, or be wary of, “yes” men or women on the boards and in senior management. A non-questioning manager or director, who goes along with orders without asking relevant questions or making proper inquiries, is a useless one. If you have a board of “mates” or “friends” you are entertaining disaster and the herd mentality will prevail. In One Tel, five of the seven directors had gone to the same school. Younger directors accepted what they were told without reference.

This was also seen in Enron, where a collaborative spirit existed. In Enron, directors had commercial interests in the one thousand special entity partnerships that the structure created. With millions of dollars at stake, who was going to “rock the boat?” The secret of huge losses in derivatives was kept until the last minute collapse of the company. This can only mean that the auditors, executives, directors had this adverse knowledge for some time before the imminent collapse. They did nothing to disclose the facts, disgorging the financial throats of employees, investors and creditors.

The fraud perpetrated by Enron has unleashed a backlash against corruption in the US. It has led to tighter corporate governance measures culminating in the introduction of the Sarbanes Oxley Act. We have now learnt that a board that is not diverse with relevant expertise is a dead board, with questionable objectivity. Corporate governance is no longer a buzz word but a strategy necessary for survival.

### **3. The conduct of a corporate investigation**

#### **3.1 Choosing the right people**

The core of any investigation is to have competent professional skills in a team. They must have the resolve to work hard and complete the investigation in a tight timeframe.

In my experience, having the right skills mix is the most important factor in a successful investigative team. Depending on the scale of the fraud, the most appropriate team will usually consist of:

- An investigative lawyer;
- A forensic accountant; and
- A seasoned financial investigator.

It is important that there is trust and equality in the team as well as a recognized leader. Each team member should understand their role and what they are expected to contribute to the team. Inexperienced people in an important investigation can contribute to conflict and disharmony, as others in the team will have to carry the workload.

Management should consider the substance of team members and place less emphasis on “talkers”. This can be achieved by asking team members what their track record is and what investigative results have been achieved. It is important to choose people who have “fire in their belly” and who are competent in actually doing the investigation rather than reporting on it.

### **3.2 Document reason and basis of investigation**

An investigative team should collate all the initial facts that have come to light. This can be done either through the complaint or information that leads to the commencement of the investigation. Enforcement agencies, by their statutes, are required to document the reasons for commencing the investigation and the use of statutory powers. Enforcement agencies can usually only commence an investigation if it is provided for within the powers of state or federal legislation for the due administration of compliance with the law.

The same procedures should be adopted in internal corporate investigations. The reason for the investigation and evidence causing its commencement should be documented clearly. Establish the reason, purposes and ambit of the investigation.

### **3.3 Investigation plan**

An investigation plan should be drawn up. This is to ensure you have a structure to your investigation. The plan could include the following:

- what are the facts to date;
- what is the best strategy to investigate this matter;
- what is the contravention/internal concern;
- who are the targets;
- who are the witnesses;
- what documents should be obtained;
- who should be interviewed;
- who will be of assistance;
- who will not be of assistance;
- where to keep documents/control procedures;
- relevant bank accounts;
- paper trail;
- phone records;

- computer records;
- need for outside expertise – forensic accountant/computer analysis;
- can documents be destroyed;
- how to secure documents;
- need for surveillance;
- need to tape interviews; and what questions need to be asked.

### **3.4 Investigation matrix**

One of the most helpful tools in an investigation is a diagram or matrix that details the relationships between parties, key transactions and events. The facts should be arranged in chronological order showing the commercial and financial transactional flows. Such diagrams are useful in all instances and help investigators assess the information obtained and what further information is required.

The matrix should include:

- bank account details;
- corporate structures;
- individuals involved;
- transfer of funds; and
- other entities involved.

The diagram should also include question marks in relation to “gaps” in evidence and detail what further information requires collection.

A further diagram can be created to establish:

- what needs to be investigated;
- how information is to be obtained; and
- what elements and information will contribute to establishing elements of contravention in relation to compliance or relevant legislation.

### **3.5 Accessing relevant law**

The investigation team should be led by an experienced lawyer or accountant in order to pinpoint applicable compliance provisions, relevant law or statutory rules. Other issues that require legal advice may relate to the circumstances of the transaction. An example of this is where a stockbroker is involved in a questionable share transaction and the financial firm needs an opinion whether the subject transactions contravened a law.

Other instances where legal advice should be sought are in audit procedures, related party director transactions and disclosure by directors. There could be many instances where legal advice should be sought. The investigative team should analyse the issues and consider what are going to be the legal “minefields” or difficult areas to investigate.

One final consideration is that it is not appropriate to use one law firm to provide all the legal advice for the corporation. A corporation or enforcement agency should consider using a “stable” of law firms to ensure independence and reduce reliance on a few lawyers. This will spread the expertise.

In relation to tape recording witnesses or suspects, law enforcement agencies have general legal powers to interview witnesses and these transcripts are admissible in evidence. However if an investigation is conducted in-house, then there are other issues that need consideration. Tape recordings or videos of interviews with consent are not illegal. The question is, can they be used in legal proceedings? Even if they cannot be used, they serve as assistance to the investigation team in the collection of evidence and in determining internally the reason for subsequent legal proceedings. However where no consent for recording the interview is obtained, or they are recorded in undisclosed circumstances, there are very serious privacy considerations as to whether such interviews are legal.

In conclusion, while conducting internal investigations, the investigator should take care when considering the evidence and evaluating the prohibitive value of the evidence. Regard should be had to individual's privacy rights and consider whether it is better for enforcement agencies to handle this aspect of the matter. Appropriate legal advice should be obtained by the investigation team prior to the collection of evidence.

### **3.6 Secure and analyse documents**

It is crucial that once an investigation is initiated, the relevant or primary documents should be secured. Enforcement agencies have special powers to obtain documents. The situation is not altogether clear in relation to internal investigations. A corporation can obtain or retain documents that it owns. But what happens if these documents are at the employee's home or storage facility? The appropriate remedy would be to obtain a Mareva injunction for the individual to hand over documents belonging to the company. However, these proceedings cannot be used as "fishing expeditions" and evidence is required that the employee has possession of the documents sought after. If the corporation is fearful of the destruction of information outside the premises of the company, they should also bring a Mareva injunction. In relation to computer evidence inside the corporation, the company should seek to capture the data using a forensic computer expert.

It is also important to secure other secondary documents or information such as computer access, timesheets, e-mails, telephone statements, facsimile printouts and office access information. Data or information collected for the purposes of evidence must be shown to be untampered and accounted for at every stage. This means from its collection through to presentation in court. If evidence is collected but shown to have no record of creation or possession, it may be judged inadmissible in a court of law. Investigators should be conscious of the need for the continuity of all evidence. They should follow set procedures for evidence collection in order to meet the requirements of the jurisdiction's law of evidence.

This information is very useful to establish a course of conduct to frame the context of the evidence. An example on point is an investigation of a stockbroker and manager suspended for front running futures[9]. The stockbroker was the subject of a complaint concerning poor advice to a young client, but he was also the office manager of the company. The industry regulator commenced an audit on his client files. The stockbroker panicked and entered the firm building at 5.30am and destroyed all the audio tape being recordings of client orders. The building access times were produced and these led to his arrest. Large sums of money were discovered in his account and evidence of market misconduct was uncovered. The internal procedures in this stockbroking firm had obviously failed as the conduct had continued undetected for a period of five years. The company did not have a compliance culture, and their compliance team was undermined and under resourced. As a result, the company lost status in the industry, suffered public humiliation and the management board was overhauled.

This example shows that obtaining a wide variety of documents and other evidence, such as building entry records, can be crucial. In this case they assisted in the investigation and led to the detection of a corporate crime. When documents are obtained, it is also important to check their source and the existence of the issuing corporation. This is particularly important for financial institutions. It also shows that if the internal procedures are ineffective and a serious fraud is exposed, it has a

financially devastating impact on the organization. Getting the internal compliance and investigation structure right only enhances the strength and ethical behaviour of corporations.

Financial institutions are involved in large financial frauds because employees overlook simple verification procedures in relation to payment of client cheques. An example of this is where investment advisers, on behalf of clients, request the redemption of investments which can be in the vicinity of \$10,000-500,000 from superannuation funds. There are numerous cases where investment advisers have forged client signatures for the redemption of payments. The financial institution then happily sends the cheque to the adviser without confirming the details with the client. One letter or telephone call to the client could prevent many serious frauds.

In one of these instances, an adviser redeemed his client's funds without their authorization for a period of two years, her life savings of \$400,000, whittled away to \$50,000. The financial institution did not make one enquiry to the client whose signature on the many redemption forms was forged. The adviser had no assets and spent the money on his gambling addiction. The financial institution repaid the client and the interest she had lost over the two year period at the request of the regulator.

### **3.7 Considerations for collection of evidence**

The collection of evidence and retaining its continuity is essential for any investigation to be successful. All organizations who conduct internal investigations should have a document control procedure and an essential place where evidence can be securely stored. Some points that need to be considered are summarized as follows:

- have a written procedure for the collection of evidence;
- document the collection of evidence, detailing, time, place of origin and circumstances of collection;
- identify documents;
- obtain relevant primary documents, ie contracts, invoices, share certificates, financial transaction documents, etc;
- obtain relevant secondary documents, eg entry documentation to buildings, telephone, facsimile and computer information;
- verify primary and secondary documents;
- secure documents inside the organization;
- be conscious of false documents and cheque authenticity; and
- consider taking legal action to secure documents outside the organization if there is a possibility of destruction.

### **3.8 E-commerce – investigations**

E-commerce technology and information as a result of the rise of the global market is essential to most organizations. Because of its nature, the misuse of the computer can be a real threat to the very survival of an organisation. Contraventions of the law in relation to the use of computers are referred to as "cyber crime". This is where information technology is used to commit or conceal an offence within the organization. This area of law is difficult because of cross border crime and the problems of investigating these types of offences. The weaknesses of e-commerce systems can be summarized as follows:

- inefficient systems;
- inadequate paper trail;

- poor IT security;
- poor maintenance of security systems;
- no internal capacity to investigate internal or external criminal breaches;
- multi-jurisdictional issues; and
- anonymity of the perpetrator.

These are all issues that make this type of crime hard to pursue.

The common view is that financial institutions are more at risk of cyber crime because of the high monetary value of the transactions involved and the perceived ability to maintain anonymity in the e-commerce environment by would-be fraudsters. The recent PWC survey of 3,634 countries reveals that 45 per cent of companies worldwide have fallen victim to financial fraud. What perhaps is of greater significance is that 58 per cent were uncovered by chance and only 15 per cent of firms have recovered more than half their losses[10].

The number of companies reporting incidents of fraud has increased since 2003. The types of economic crime in the recent PWC survey shows:

- 71 per cent increase in the number of companies reporting corruption and bribery;
- 133 per cent increase in companies reporting money laundering; and
- 140 per cent increase in the number of companies reporting financial misrepresentation[10].

### **3.9 Interviewing witnesses with consent**

Enforcement agencies have clear powers to interview suspects after appropriate warnings and notices are issued. However, in conducting corporate investigations, audit committees, management and investigation staff may be required to interview persons with their consent. This assists the investigations for breaches of compliances, audit procedures and statutory breaches. The purpose of such an interview is to obtain information, not grandstand or put the person “off side”. If witnesses are interviewed, the investigator should have prepared a form or questions. These should be wide enough to be flexible but should have a structure to the questioning that sets out to establish the required evidence.

The most important rule is to listen and let the interviewee do the talking. The second most important rule is to be organised and for the investigator to control the process.

The interviewee should be asked to attend in a private office at a time and place in an area controlled by the investigative team. The interviewee should be asked if they consent to the conversation being recorded. It should be explained to the interviewee what the investigation is about. This is helpful to both parties because it prevents interpretations being placed on information. It also allows the investigator to concentrate on what is being said, rather than taking long notes.

Usually the interviewees are intelligent people and there is no need for a heavy handed approach. However, the investigator should be firm and, at times, will be required to be aggressive, depending upon the circumstances. However, experience shows that as soon as the investigator becomes too aggressive, the interviewee can become selective and will volunteer only to answer the questions asked.

An interviewee should be made to feel that they are assisting with the investigation. If this is achieved, a relaxed interviewee will often volunteer more information which may assist with the investigation.

The interview is not a forum for cross-examination, but for information gathering. If cross-examination techniques are used then often little is achieved. However, it is important for the investigator to use assistance language, “can you help me?” “can you be of assistance to me?” or “I do not understand some issues”.

When interviewing, it is paramount that the investigator is courteous, considerate and well mannered to the interviewee.

### **3.9.1 Pointers**

- The purpose of the interview is to obtain information, not to cross-examine;
- listen and learn;
- prepare questions but be flexible;
- have a set of essential key questions;
- be organized and control the process;
- the interview should take place in a private area;
- request consent to record the conversation;
- record the conversation;
- explain to the interviewee what the investigation is about;
- use language that requests assistance;
- be firm with the questioning;
- do not be hard headed or aggressive; and
- be courteous and well mannered.

### **3.10 Instinct**

Investigative instinct is very important in conducting complex corporate investigations. In many instances, investigators ignore other possibilities because there is no evidence, rather than using instinct to lead them to evidence. This is not to suggest that investigators should go on frolics of their own, but think laterally and outside the square.

The value of instinct can be shown by an example of an investigator involved in working on an international fraud that involved a couple of million dollars.

The fraudster left Australia two days before the fraud was detected. The quick action by the investigator prevented and retrieved \$2.2 million of investor funds from being paid into an account of a female friend of his in London. However, despite all avenues being pursued (including the help of Scotland Yard), the fraudster disappeared in England. The investigator uncovered that he had bought a ticket to the West Indies and initially it was believed he had departed to that jurisdiction.

Searches were requested for the fraudster’s whereabouts in the West Indies, without result. Instinct told the investigator that the West Indies ticket purchase may have been a “smoke screen” but he did not know why, but this thought kept on nagging him. There was no evidence to suggest otherwise, but his “feeling” for the evidence and facts led him to believe that the fraudster was elsewhere. Credit card statements had been obtained without result – they were not being used.

For weeks the investigator thought and digested the information he had, then late one night it suddenly came to him. The fraudster may be using his Air Mile points on his credit card to purchase air fares, rather than the credit cards themselves. The investigator made phone calls to a number of airlines internationally who confirmed the fraudster had flown from London to Beijing using his Air

Mile points. A year later the fraudster was extradited from Hong Kong and is still serving seven years for a large investment fraud.

Those few telephone calls were direct actions as a result of instinct and lateral thinking though not necessarily based on any evidence. This example shows that it is important not to ignore instinct and it should be considered a tool in the investigative armoury. Instinct in a legal and investigative process is simply pursuing all avenues of possibility and considering options that arise that need further enquiry, not necessarily based on evidence or facts collected at the time.

### 3.10.1 Pointers

- use your instinct;
- explore all possibilities and write them down;
- think outside the square;
- brainstorm ideas; and
- have the resolve to follow issues up no matter how unimportant they may seem.

### 3.11 Knowing what to look for

There is little use in conducting an investigation unless you have professionals of substance who know what they are looking for and have a methodology for achieving it.

It is interesting how many senior compliance persons, auditors and investigators have never uncovered any frauds in their corporations. This is more surprising when regulators or enforcement agencies, when investigating frauds, reveal that the fraud or compliance breach had been going on for a number of years. The corporation should then question the compliance standards and procedures in place and the substance of the incumbent compliance officers and auditors. An example of professional inadequacy is given by Frank Abagnale[11] in his work where he gives an example of a man who showed up in Salt Lake City claiming to be an official with the Russian Olympic Team in advance of the 2002 Winter Games. In just three days, bank officials cashed fraudulent cheques to the value of \$US90,000[12].

The most important issue to arise out of recent corporate collapses is the conduct of auditors and whether the audit oversight committees have exercised their duties properly. It appears that although audit procedures have been put in place, fraud has occurred in new ways.

The ineffectiveness of audits and how sidetracked they get, is exemplified by a consideration of the auditor's enquiries into Nick Leeson at Baring Bank, Singapore. More recently, in the Parmalat investigation, the auditing firm, Grant Thornton, referred to itself as a "victim". Does this mean that the frauds are so intense and deceitful that we no longer realize what we are up against?

Barings London collapsed in the early 1990's as a result of Nick Leeson hiding his Symex losses. No less than two audit teams were sent to consider Nick Leeson's option trading positions on the Symex and Nikkei indexes. Obviously, no-one, including management in London, understood his hedging and arbitrage positions and the sophistication of this type of trading. Leeson had a special secret account "88888" for hiding his trading losses that went on for nearly two years. Leeson could not believe that he was not caught, as he was constantly calling for large sums of money from London to cover his position hedging call on fluctuating losses. Any audit should have revealed his secret loss account and an explanation as to why large margin calls were being made.

In particular, it appears that the audit team made no enquiries of the exchanges of the regulators he was dealing with. In his book *Rogue Trader*, Leeson claims the audit teams discussed the football and overseas travel and his bosses. They were more concerned with bonus payments and him making more paper profits than monitoring his trading positions. In other words, no one had their

eyes on the job at hand or understood his loss position and the nature of the fraud. Barings had been a banker to Britain's Royal family for three hundred years and its failure to have adequate audit investigators who understood the business, together with an independent investigation team, contributed to the failure of the bank. In the end Barings was sold to ING for \$1.

Among more recent alleged frauds in the market are Livedoor Executives who are suspected of violating securities exchange laws in Japan. They are alleged to have "window dressed" the accounts of group companies and provided false financial information to manipulate the shares in Livedoor and thereby created a false market ([15] *Financial Times*, 2006e). If so, this is a repetition of history in the Worldcom/Enron vein. The outcome of the Enron trial, which will have important ramifications for corporate America, will be of great interest for those who wish to learn more about how corporate frauds may occur[13]. The trial has revealed that the orders to commit one of the largest frauds in history, came from the two most senior individuals on the board. Their request to the Chief Financial Officer was to use his financial "magic" to create a complex web of partnerships with fictitious assets to give Enron extra "juice" to falsify earnings. Frauds from the top are very difficult to fight.

These recent examples of alleged corporate crime indicate that internal auditors, accountants and investigators must know what they are looking for. If not, it can have serious consequences.

Governments can also feel the ramifications of alleged fraud which is reflected in the recent David Mills – Silvio Berlusconi trial in Milan. It relates to a ten year old bribery investigation affecting Tessa Jowell, UK Minister of Sport and Culture, who is the wife of Mr Mills[14]. The case has highlighted disclosure and corporate governance issues relating to ministerial codes of conduct.

Not many people are now beyond the reach of the law internationally. Executives who collaborate with others internationally and who are partly involved in the fraud are not out of the reach of international regulators. This is recently emphasized with the possible extradition from the UK to the USA of three former Natwest Investment bankers who lost a fight against extradition to face Enron-related fraud charges[15].

What is happening now in relation to high profile frauds? There is a greater willingness of authorities to pursue alleged criminals overseas and pursue them relentlessly. This sends a strong message for the future.

What the world economy does not want to see happen is the excessive increase in costs of global compliance so that it infringes on their commercial enterprise or damages the companies' pursuit of their legitimate business interests. In essence, a company must have the right systems and compliance in place which are also cost effective to avert a disaster. Accordingly, care must be taken in developing effective compliance programs that employ the right skill mix of individuals.

### **3.11.1 Relevant points**

- Have people of substance in compliance/investigative positions
- Be aware of the compliance/investigations where fraud is uncovered.
- Encourage an environment of compliance. It may save your company.

### **3.12 Timely investigation and referral to enforcement agencies**

Corporations have the propensity to keep a lid on their dirty washing. They fear that their reputation will be tarnished if the fraud is made known. International corporation laws require timely referrals of suspected contraventions of the law. However, it is interesting that in many cases, these referrals take two weeks or so to be reported. It is often in circumstances where the person knows they are being looked at by compliance. The consequence is that documents can be destroyed, electronic messages erased and money can also be transferred offshore. When a compliance breach comes to

light it is important that it is considered in a timely manner and internal procedures are put in place to secure evidence.

The breach may lead to other matters that have to be considered, also requiring a review of an expanded scope of transactions. An example of a wider scope of investigation is where a manager of a stockbroking firm had three companies on his client list who were in the top three performing clients. A complaint was received on one of his client files about poor advice. The compliance officer reported the complaint and reviewed all client files with the regulator. The investigation revealed that the stockbroker was the *de facto* director of the three high performing companies. His interests had not been disclosed and he had used the firm's information to advance his own financial interest. This example shows that one complaint or concern may lead to other breaches and reveal the need for a fuller investigation.

#### 3.12.11 Pointers

- Conduct timely internal investigations when breach reported.
- Make timely referrals to enforcement agencies.
- Note that the whole course of the person's conduct may have to be reviewed.

### 4. Investment fraud

Investigating numerous corporate frauds reveal that the victim whether it be the investor or the company, rarely seeks independent verification through official channels before handing over funds. Most corporate/investment frauds could be avoided. They can be detected through sensible enquiry and by investors not believing in high returns or reports of corporate success. Investigations show that investors need further awareness and education. They should check basic facts, such as whether an adviser is licensed or whether there is a prospectus reflecting the information registered with the relevant securities commission.

Evidence reveals that in some large frauds involving bogus banks, insurance companies or international managed investment frauds, not a single investor telephoned the Central Bank, financial regulator or informed their lawyer or accountant. The extent of mistakes made by investors and consumers revealed through corporate investigations leads to the conclusion that it is not always greed which is the prime initiator to invest. It is the lack of economic understanding and investment knowledge as to what constitutes a realistic return. In the future, there is no doubt that financial education will start at school. Governments cannot afford their citizens to lose substantial sums and thereby compromise a person's financial independence leaving the state liable for their welfare. Developing regions such as the United Arab Emirates and Kuwait are now experiencing an increase in financial crime. Accordingly, these economies will have to obtain appropriate expertise to fill in the short term gaps to combat fraud.

A healthy suspicion is not a bad starting point for investors. They would do well to check basic points, such as whether the company is legitimate, are other large institutions recommending that type of investment, is there a registered prospectus, etc. If the investment return is higher than other blue chip investments, then investors should be on guard and appreciate the greater risk involved. This does not mean that they should not invest, it means they should understand the concept of risk and return in economic terms.

In essence, it appears that many frauds can be avoided if the investor seeks independent verification of:

- The financial adviser's qualifications and license;
- whether a prospectus is registered with the regulator in the jurisdiction;
- whether the investment is recommended by well known financial institutions;
- searches of the relevant institution in the country of origin claimed;
- advice from an adviser;

- bankruptcy/company searches; and
- director searches.

An example of a devastating investment fraud is the British Marine Bank fraud. George Balos marketed a fictitious bank, “British Marine Bank” in Australia. They did this through financial advisors targeting elderly people. The elderly were duped into entering into a British Marine Bank loan with returns of 5-7 per cent per month. The bank had “official” documents obtained from the Philippines. The name of the bank was chosen by George Balos’ confidante through numerology. The bank was supposed to exist in the Dominion of Melchizedek, a non-existent dominion of Israel. Over 300 investors gave George Balos \$11 million over two years, through two licensed financial advisers operating in Sydney and the Gold Coast. Many investors were introduced to the “bank” by friends or family who were impressed with false statements about the performance of the investment.

Investors received their false monthly statements on impressive gold embossed bank letterhead and enthusiastically watched their 25 per cent per annum investment grow via the issued bank statements. The letterhead gave addresses of the bank in Sydney, London, Zurich and Israel. The trouble was that Balos was gambling the money at casinos in Melbourne and London and the advisers received 20 per cent of what they gave the master. The Australian Securities & Investments Commission prosecuted George Balos who was sentenced to 11 years imprisonment. The financial adviser who assisted Balos, was extradited from Hong Kong and sentenced to seven years.

Not one investor made initial searches of any kind before investing, despite large amounts of money (between \$50,000 and 300,000) being “provided” to Balos. Most investors did not act out of greed, but believed in the story of better returns “offshore” and the genius of Balos’ investment strategy. The genius of Balos would have been uncovered by a simple search. George Balos was bankrupt.

If we are to advance, we must learn from mistakes. In this case, large financial institutions allowed the elderly investors to withdraw cheques from well-performing managed investment funds without asking them any questions. Financial institutions should perhaps inquire why an investor is withdrawing the investment from a fund, especially when that investment had been there for some time.

There are countless investment scam warnings in media releases and on the websites of security regulators all over the world.

### **8.1 Pointers to avoid investment fraud**

- Make relevant independent enquiries with the securities regulators and relevant industry bodies about the individuals involved.
- Ask an established investment adviser about the product.
- Employ a healthy dose of suspicion if there are high returns.
- If the institution is offshore, make the enquiry of that jurisdiction.
- Conduct bankruptcy searches of the principals.
- Conduct licence adviser or prospectus searches of the relevant regulator in that jurisdiction.
- Obtain independent advice before you go ahead.
- Do not rely on a “friends” say so.
- Be ware of investments where you are asked to transfer funds offshore to “island states” such as West Indies, Bahamas, British Virgin Islands, Vanuatu, South American countries and Eastern Block countries.

- Financial institutions should question investors on large withdrawal amounts and assist them with relevant searches.
- Consult investor warnings given by regulators on their web site.

## 5. Audit fraud

An audit fraud has materialized as a new dimension to corporate fraud with drastic consequences.

Worldcom insolvency of \$US30 billion was a classic audit fraud. Worldcom admitted booking expenses to capital expenditure by turning losses of 2001 and the 2002 March quarter into profits[16]. Its auditor, Arthur Andersen, did not detect the fraud. It was uncovered by Worldcom's audit committee which discovered the company had incurred up to \$US3.8 billion in costs, not properly accounted for. The booking of expenses to capital expenditure allowed the company to write its costs down over time rather than immediately.

More recently, in the wake of the Parmalat fraud, complex securities instruments such as derivatives and other financial instruments are playing a greater part in these frauds. Transactions can be set up as investments, and not a loan, which of course is a legal manoeuvre. The consequence was that the borrowing costs appeared smaller than what they actually were. False accounting played a significant part with managers in the Parmalat Group inventing assets to offset as much as 16.2 billion in liabilities over a 15 year period. It is not clear how the auditor, Grant Thornton, remained unaware of the accounting fraud. What is clear is that the web of offshore company structures made the fraud difficult to detect. The lesson is that the control through a chain of holding companies makes weaknesses in corporate governance difficult to detect and a fraud easier to perpetrate ([7] *European Business*, 2004; [8] *Executive Intelligence Review*, 2004).

## 6. Market disclosure

The technological boom from the end of 1999-2001 unleashed bullish speculation in securities. It also precipitated serious non-disclosure to the market about factors that may have dampened investor enthusiasm concerning companies long before their demise. Failure to disclose to the market is perceived as a corporate fraud. However, it is a new type of fraud. This is because the failure to disclose material issues to the market goes to the very heart of the financial system that is based on a level playing field economic philosophy. That said, there has not been a great deal of action by regulators for the very good reason it is very difficult to uncover.

Each day investors buy shares on the basis of information and perception. If that information changes adversely, to a material level, and is not disclosed then the investment is made on a false misapprehension. If the relevant information was disclosed, the investor may not have parted so readily with his money. The tech stock boom showed that companies can successfully run the index for over a year under a mask of false confidence. These days other investors are more aware of the issues and are likely to pick up non-disclosure. Enron and Parmalat serve as an example that shareholders should have a healthy suspicion when they read company accounts.

## 7. What can be done to combat corporate crime?

### 7.1 Director education and awareness

One thing is clear is that the more complex an organization, the less effective the controls. Many companies in Europe are family controlled through chains of international holding companies, making corporate governance and supervision by regulators more difficult ([7] *European Business*, 2004; [8] *Executive Intelligence Review*, 2004). In these circumstances there is a higher likelihood of fraud. The starting point is director education of what is involved and what compliance structures need to be put in place to combat fraud.

When the Worldcom fraud was uncovered, Worldcom announced that "our senior management team is shocked by these discoveries"[17].

The majority of directors were not aware of the fraud until too late. Directors often sit in their executive suites and receive reports, consider them and feel self assured. How often do they go down the ranks and talk to staff and ask questions about operations? Firstly, directors should find out about fraud as a concept and understand the different types of fraud and the circumstances in which it can occur. Directors can oversee the development of fraud awareness programs for staff and keep abreast of fraud issues emerging in their areas of business. One read of “Art of the Steal” by Frank Abagnale[18], will explain e-commerce has made fraud child’s play.

## **7.2 Review internal and audit procedures and put systems in place**

Fraud is a commercial amoeba that is ever evolving. How it looks today, will be different tomorrow. Authors [4] Chapman and Smith (2001) noted that from “the information currently available, financial institutions are frequently targeted by fraudsters who often inflict considerable financial harm on the organization”[19] ([4] Chapman and Smith, 2001). Other research indicates banks lose five times more to embezzlement than to armed robbers[20] ([4] Chapman and Smith, 2001). The picture does not seem to be changing in 2006 except that Enron and Parmalat show that the Trojan horse is often made from within.

Currently, the Bank of China (BOC) is preparing for an initial public offering in the coming months and has an investigation underway in relation to an internal fraud of US\$57.7 million through one of its branches. The bank is contemplating a Wall Street listing involving some of New York’s most prestigious banks. The revelation of such a fraud will have reputational and commercial implications for the BOC who will need to tighten up on its compliance structures.

Research indicates that cheque manipulation and forgery are the most common document frauds, accounting for 50 per cent of offences ([20] Gibbons, 2002). A KPMG study shows that 73 per cent of large frauds are committed internally ([20] Gibbons, 2002, p 71). Paper frauds are not easy to detect because most fraudsters use technologies that produce near perfect results ([10] Gibbons, 2002, p 72).

This discussion emphasizes the need for corporations to review and update audit and accounting procedures. They need to be aware of arising e-commerce and paper frauds and the difficulty of detecting frauds. The directors should ensure that the company has the internal capacity and skills to investigate sophisticated corporate frauds.

## **7.3 Fraud awareness program and policy**

In a recent speech in the UK, the Director of the Serious Fraud Office emphasized that we should not underestimate the cost of fraud to the community and business[21].

Each company should have a fraud awareness program[22]. The responsibility for detecting fraud is clearly at the feet of directors and senior management. However, compliance programs should be created in consultation with staff, directors and senior management, ensuring auditing and accounting compliance mechanisms are sufficient to detect fraud.

A fraud policy will allow for independent investigations and indicate procedures to be followed. If employees understand from fraud awareness programs that there is a clear structure for reporting fraud and dealing with the problem, then it will encourage the reporting of suspicious transactions to management.

In [6] Coderre’s (1999) work on fraud detection, it is suggested the contents of a fraud policy should include:

- a statement of the company’s intent to prosecute persons who commit fraud;

- a clear statement of who is responsible for the deterrence, detection and investigation of fraud;
  - guidelines and procedures for the handling of suspected fraud or allegations of fraud;
  - instructions on who will be notified at various stages of an investigation of alleged fraud;
  - criteria for determining if and when legal, law enforcement and regulatory agencies will be involved; and
- Guidelines for reporting and publishing the results of fraud investigations.

#### **7.4 Foster trust and be open about whistle blowing**

A whistleblower is defined as a person who exposes or brings to executive or public attention any irregularity or crime from within an organization[23]/ Whistleblowers are often courageous and are conscious of a deep sense of wrong. Mostly, they gain nothing by coming forward and often act in the public interest. In one of the few articles on the subject by Professor [21] Latimer (2002) makes the point that very little reward is given to whistleblowers for their trouble, “of 23 whistleblower studies, 90 per cent were sacked or demoted for their pains and 27 per cent faced law suits, usually for breach of confidence and defamation”.

The question is, could a whistleblower have limited the damage in Barings, Tyco, Enron, HIH, Worldcom and Parmalat before their collapse? It is quite possible that if directors were alerted to arising issues they may have been able to avert the losses involved. The FBI whistleblower who warned of the failure of collaboration between the CIA and FBI over non-sharing of terrorist information is a poignant example of how structures can be in place but are not effective. In this case it was disclosed that there were significant problems of communication between the agencies and the flow of intelligence information was not timely or efficient. Obviously, this was not in the national interest and President Bush has taken steps to deal with these issues with the aim of both organizations working together effectively.

Likewise, in corporate governance, you can have pretty charts and structures for “looking good” governance, but an effective adherence to the requirements. How does your organization fair?

Nobody wants to talk of corporate issues of concern because they are regarded as sacred cows and the “shoot-the-messenger principle” is very much alive within corporations as there are political agendas at stake. The individuals who bring these issues to the attention of senior management are usually not popular and suffer as a result. In many instances they are stating what everyone knows, but others are too afraid of the repercussions to say it. There is a high probability that this is where the early warning signs of a major fraud will come from. How will your organization be placed to deal with it?

#### **8. Conclusion**

Corporations must learn and adjust to the new types of frauds both structured and unstructured. Recent events teach us that corporate economic crime is global and if unchecked, can bring down the entire company together with its external advisors. No amount of legislation and regulations will stop director or corporate misconduct.

Often, poor ethical and moral judgment, by those in senior corporate positions, has allowed conduct to go unchecked because of a lack of adequate procedures and processes. More importantly, because of their position, directors are often not open to compliance and investigation scrutiny from within the company.

Is your company “house” in order and able to deal with economic crime within your organization?

Do you have good people with a track record standing guard ready to conduct an effective internal investigation when the time comes?

If there is anything to be learnt it is – we must be vigilant within corporations and have effective corporate governance and compliance structures that are not only there but work effectively down the chain of command. These compliance structures must be flexible and innovative in their operations to combat new and emerging frauds. There is little doubt that in the future many corporations will have to have the ability to conduct internal investigations or outsource investigations within a very short time frame. Corporate fraud can only be confronted where there is a willingness within corporate governance to see it as a real danger and deal with the Trojan horse before it can be built.

#### PWC Global Economic Crime Survey

#### [Footnote]

1. This is an updated paper based on Vchapter 11 of Mr Cobern's work, *Coburn's Insolvent Trading: Global Investment Fraud and Corporate Investigations* published by Law Book Co; Thanks is given to Joyce Maykut QC, Mark McGinness, Christine Murphy and Robyn Hughes.
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2. Enron, Worldcom, HIH, Ansett, Parmalat & Tyco to name just a few.
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6. Jackie Corr, "The First Enron Memories of the New Deal" and Ferdinand Pecora, "The Hamster" (2002) p 2.
7. Roger Darvall-Stevens, unpublished paper presented at Corporate Crime Workshop, Monash University, January 2002.
8. Roger Darvall-Stevens, unpublished paper presented at Corporate Crime Workshop, Monash University, January 2002, Coderre, p 11.
9. Front running is where a stockbroker receives client instructions, immediately buys the same order himself and then on-sells the futures to the client making an instant profit without risk.
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#### [Appendix]

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