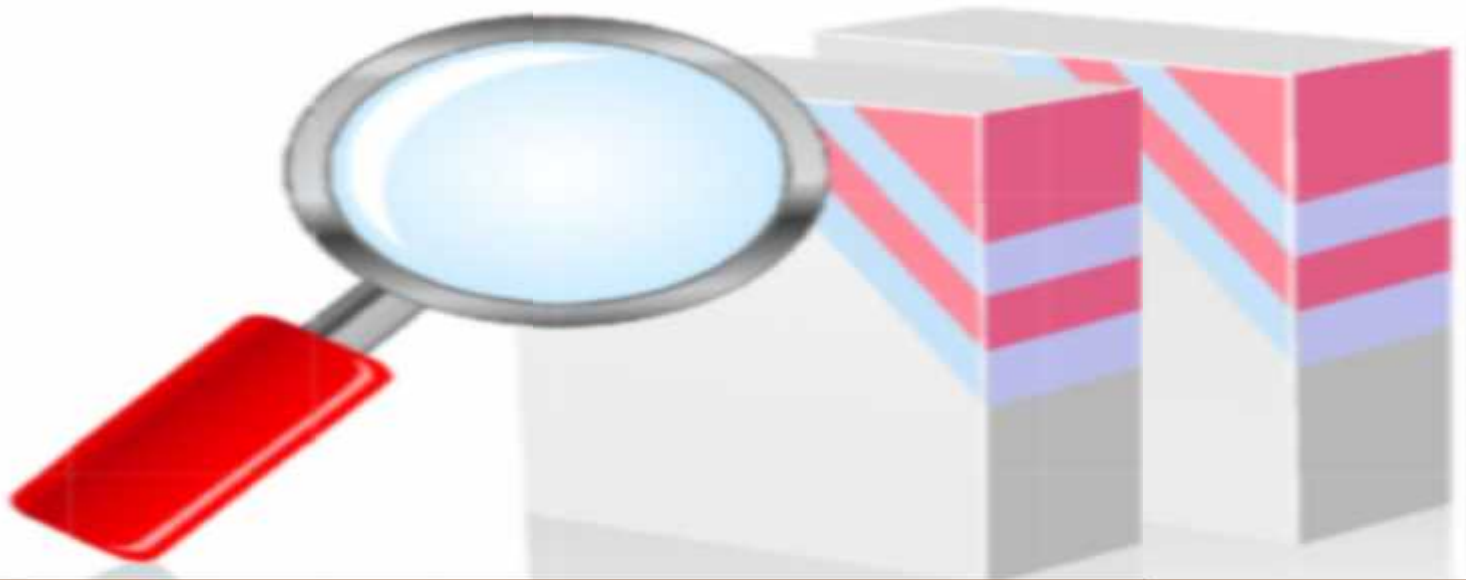




UNIT-2

Crime and Economy

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Identify different types of financial crimes.
- ✓ Assess the elements of effective fraud investigation.

UNIT 2

Crime and Economy

Introduction

Crime has significant effects on society, and these that can be studied through two major approaches:

- **Microeconomics**
- **Macroeconomic**

Microeconomics evaluates the effect of crime on businesses and individuals, while macroeconomics analyzes the influence of crime on local communities and domestic and global markets. The impact of crimes on the daily activities of the common man and businesses can be recognized easily. However, understanding the consequence of crimes on communities at national and international levels can be difficult for most people and companies.

Microeconomics

Microeconomics studies the influence of crime on individual consumers and companies. A victim might be an individual or a business. Victims are primarily and directly affected by the loss of money or property. The amount of property or money may be determined after the criminal has been prosecuted, but in some cases this is not possible. In some crimes, the reputation of the victim suffers a loss. In these cases, there may be no apparent economic loss; alternatively, the cost to the victim may be massive. However, the overall costs to the local community and the nation can be huge.

Macroeconomics

This branch of economics studies the effect of crime on local communities at regional, national and international levels.

Cost Reality

The cost of crime to the local community and the nation can be huge. A few components of the cost of crime are given below:

1. Law enforcement

Law enforcement carries costs incurred in training and maintaining a police department, their equipment and buildings, and their support staff.

2. Prevention of crime

Community programmes are developed to help prevent the occurrence of crimes. Common programs include Crime Stoppers, school programs and other programs supported by the tax money paid by the local community.

3. Drug rehabilitation and prevention

These programs are supported by both private and public funding. Private organizations and governments offer programs for the prevention of drugs and alcohol abuse and the rehabilitation of the users. Such programs cost money to the patients and taxpayers.

4. Incarceration

The facilities provided to prisoners cost substantial amounts of money provided by taxpayers. These include expenses for food, housing, clothing, medical care, supervision and training for inmates in jail.

5. Courts

Operating and maintaining the legal system carries considerable costs for taxpayers. These include costs for judges, court reporters, clerks, buildings, etc.

6. Prosecutors

The costs of employing lawyers, their support staff, office buildings, and all the accompanying costs of operations are huge, particularly in large cities.

7. Public defenders

In many cases, the defendants are unable to meet the expense of hiring defence attorneys. In such situations, the taxpayers' money pays for these expenses. These costs include fees for the defence lawyers and their support staff, operating expenses and maintenance costs.

8. Hospitalization

Healthcare expenses carry a significant overall cost to society. The costs of medical treatments required by the criminals' victims and others working within the justice system are quite significant. As the occurrence of AIDS and other deadly diseases is on the rise, this expense has gained even more attention.

9. Businesses

When employees or customers steal from businesses through trades and dealing, the businesses in turn take measures for their survival; these may include increasing prices or laying off employees to deal with the expense.

10. Insurance companies

When individuals and businesses with insurance coverage suffer from crime, they file claims for these losses. This causes insurance companies to charge higher premiums to people and businesses.

Financial Crimes

There are many types of financial crime. Substantial time is required to collect vast amounts of financial records to support a conviction in complex financial crimes. However, the common factor in all financial crimes is greed. Given the opportunity, even the most truthful and trustworthy individuals may commit fraud.

Three factors that may be seen in financial crimes are:

- 1) The presence of something valuable.
- 2) An opportunity to take something without being detected.
- 3) A perpetrator willing to commit an offence.

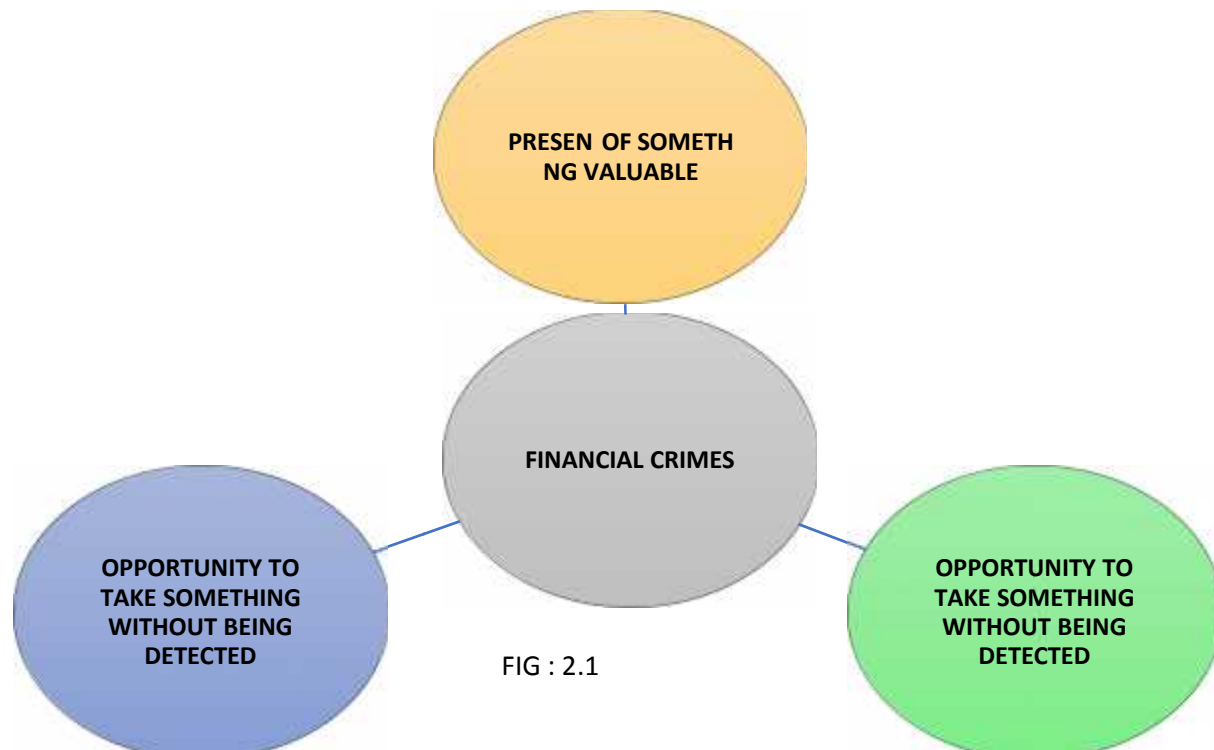


FIG : 2.1

The most common financial crimes are described below:

Arson

According to law, malicious and intentional burning of another person's dwelling is defined as arson. The crime is concerned not only with the resulting damage to the property but also the threat to which the occupants were exposed due to this action.

A dwelling can be broadly defined as any building. Setting fire to timberlands, grasslands or plains is a statutory offence. However, the burning has to be malicious or wilful to be categorized as arson. An individual who burns a dwelling while committing an offence such as a break-in is guilty of arson irrespective of the absence of any intent to start the fire or damage the house. Slight burns, smoke damage, or staining of the building without any disfiguring, destruction or actual burning are insufficiently serious to be called a crime of arson. The real burning of some part of the property must have occurred to warrant a charge of arson.

Bankruptcy

Bankruptcy fraud is mainly non-disclosure or hiding of assets. When creditors face difficulty in recovering their losses, the situation is known as a 'bust-out'. Bust-outs have been occurring more frequently in recent years, particularly in businesses with high turnovers.

Bribery

Bribery involves an offer and acceptance of funds or favours for some type of special treatment or for influencing another party for such treatment in either a private business or in public service. Investigating kickbacks or bribery is difficult, as such crimes are hard to trace through records and books. If such a payment is uncovered, it is still quite challenging to find out who actually accepted the payment.

Loan-Sharking

Lending money at higher interest rates than permitted by the law is called loan-sharking. Many people become involved with loan sharks, such as gamblers who have to pay gambling losses, or drug users borrowing money to buy drugs. Businessmen may also become involved in loan-sharking when legitimate credit channels are closed.

Credit Card Fraud

Credit card frauds are controlled by organized crime and generally follow a classic pattern. They start with credit cards being stolen, fenced, and sent elsewhere. The stolen credit card is then used before the credit card holder can report its loss, or before the issuing bank can warn its subscribers about the theft in order that the appropriate action might be taken.

Credit cards are usually obtained in the following ways:

1. During the course of delivery.
2. During the printing process, or by being duplicated.
3. When returned to the issuer if rejected by the applicant or if it could not be delivered.
4. When business employees omit to return credit cards to their clients intentionally.
5. When they are counterfeited.
6. When stolen during a street robbery.
7. When credit card numbers are copied from genuine clients and used for purchases.

A person who uses a credit card with the intention of gaining money, products, services, or anything of value without the permission of the cardholder is committing credit card fraud, and this is known as fraud by the customer. Credit card fraud is also committed by businesses.

Mail-Order Procedures

Such operations involve dishonest schemes marketing products in the media, such as newspapers, the Internet, radio, magazines, or television. Buyers send payments to the mail-order house. The mail-order house receives the funds but intentionally fails to ship the products. This is commonly known as a 'boiler room' job.

At times, the operators use high-pressure sales people who make phone calls and persuade clients to buy the products using convincing arguments about the high value of these products.

Skimming or Embezzlement

The process of diverting business income to one's personal use is known as skimming. This fraud can only be carried out by the owners or officers of a business enterprise. When such diversion of business income is done by a member of staff, it is called embezzlement. Cash businesses are increasingly susceptible to embezzlement and skimming, such as grocery stores, bars, nightclubs, liquor stores, or coin-operated machines. In most such crimes, the embezzled or skimmed money cannot be traced from the business organization to the perpetrators.

Stock Fraud and Manipulation

Criminals also achieve illicit gains through stock and bond fraud schemes. Fake stock certificates are used as warranties for loans. Dummy corporations are created to sell useless stock in boiler room operations. A legitimate company might be bought and sold repeatedly between insiders to inflate the stock's market price. After the stock has been sold at greatly inflated prices, the corporation will be deserted and the stock will fall to the correct market value. Fraud involving stocks and bonds is very sophisticated and complex. Very detailed investigations and analysis are necessary. An investigation of transactions before, during, and after the scheme is required to establish the trends.

Non-Profit Organization Fraud

Scores of fraud are committed in this category, but this is mainly a tax fraud. Different types of non-profit organizations are allowed to operate without paying taxes and having to acquire licenses and permits, and they are exempt from several laws and regulations set by the Internal Revenue Service and state legislators. These non-profit organizations are generally very helpful to their members and the community within which they function. Religious organizations, various charities, social clubs, and paternal societies are a few examples. However, some such organizations are controlled by individuals who run them for their own personal benefit, which is illegal.

Forgery and Uttering

The deceitful making or material modification of any writing with the intention to deceive or harm another person's rights is called forgery. The intention to deceive is the basis of the crime of forgery. Forgery may be committed in several ways, such as writing with pencil or ink, by typewriter, carving, printing, or even pasting one name over another. The crime of forgery must have the following two features:

1. The signature was not made by the person whose signature it is meant to be.
2. Someone made the signature illegally.

Even if the name suspected of having been forged is in fact a fictitious one, it still falls under the crime of forgery. Signing a fictitious name on a cheque with the intention to commit fraud is forgery even when the cheque has been made payable to cash. It is not essential that the forged signature should resemble the original one. Forgery may be committed by an individual signing his own name where his name appears to be the same as that of another person and he intends his writing to be taken as that of such other individual. Generally, a mere unimportant change or modification of the signature that does not affect the legal liability of either party concerned with the instrument involved is not forgery.

Offering of a forged instrument with the intent to deceive is called uttering. Specific examples of uttering or publishing are:

Presenting a fake license as evidence to receive compensation.

Depositing a fake cheque to a personal account.

Delivering a forged note to pay a debt.

Obtaining certification of a forged will.

Using a forged instrument in court.

Tax Evasion

A deliberate attempt to escape or avoid paying tax is called tax evasion, and governments have laws that make it a crime. Wilful tax evasion or avoidance is a crime committed when fraudulent or false returns are deliberately and knowingly filed. Tax evasion has to be proved by an affirmative act. Wilful failure to collect or pay tax is a crime that must be proved through affirmative action.

Bank Frauds

Both customers and bank employees can be involved in bank frauds. A bank fraud includes passing bad cheques, cheque-kiting (issuance of a check with insufficient funds) and fraudulent loans. Officers or employees commonly steal funds from banks through different schemes. Customers commit bank fraud by writing bad cheques or presenting incorrect documents to obtain loans.

Government Contract Fraud

Many federal statutes involve fraud against the government for goods and services and can be classified into the following categories.

1. Deceitful billing for products and services.
2. Defective or inferior products or services.
3. Delivering replaced products instead of original products.
4. Overpricing on contracts with the government.

Corporate Raiding

When organizations or individuals take over business entities to exploit the business assets for financial gain, this is called corporate raiding. Corporate raids may be carried out for personal gain or for acquiring control of the industry. Corporate raiding usually includes offences such as pension fraud, embezzlement, bankruptcy fraud, stock fraud or stock manipulation.

Extortion

Extortion involves threats made by one person to another to obtain money. This crime is usually committed by criminal groups in their areas of operation; however, they do not exercise market control in such crimes.

Coupon Fraud

It is usually individuals in control of businesses who commit this crime. In coupon fraud, the business person collects different coupons and submits them to the company that distributed them, claiming discounts on products that fake customers have purchased from the business.

Money Laundering

When persons or business entities conceal gains from unlawful activities through various schemes and methods, it is called money laundering. Money laundering events include:

1. Transfer of money and other monetary instruments to and from overseas.
2. Buying various tangible and intangible properties with large amounts of cash.
3. Depositing large amounts of money into different financial organizations.
4. Maintaining offshore bank accounts with huge balances.
5. Transmitting money on the public's behalf, whether overseas or within the country.
6. Any money derived from unlawful activities.

Medicare and Medicaid Fraud

This crime is committed by different health care providers who submit claims to government schemes for products and services that were not provided, or who overcharge for such products and services.

Computer Thefts

Computer crimes are perceived more as the means of committing crimes than actual crimes in their own right. As tools for committing crime, computers may be used by criminals to victimize individuals, their own companies, competitors' companies, governments, the public, or even other countries. Computers are used for committing crime in the following ways:

1. False claims can be submitted to government organizations or employers.
2. Funds can be embezzled from financial institutions or employers.
3. Prices of stocks and bonds can be manipulated.
4. Any information likely to be harmful can be deleted.

5. Any information that could disrupt day-to-day business activities can be deleted.
6. Company secrets or software can be sold.

Insider Trading

Insider trading crime occurs when corporate officers or employees of companies with knowledge of their company's internal activities trade their bonds or stocks on the various exchanges.

Corporate Fraud

Corporate fraud includes crimes by organizations or against administrations. These frauds can be committed in the following zones:

1. Company secrets can be stolen by employees for financial or other gains.
2. Company secrets can be stolen by corporate organizations, generally known as corporate espionage.
3. Patent and copyright infringements.
4. The manufacturing, distribution and trading of harmful food products and drugs to the public.

Conspiracy

When an individual agrees, confederates, combines or conspires with another individual to commit a criminal offence, he or she commits a felony. Generally, the punishment for conspiracy is based on the kind of crime that the individual is contriving to commit.

Identity Theft

Identity fraud or theft is a type of crime in which someone illegally attains and uses another individual's personal data in ways that involve deception or fraud. Characteristically, it is committed to obtain financial benefits. Personal data, particularly bank accounts, Social Security numbers, telephone calling card numbers, credit card numbers and other valuable data can be used to gain benefits at the victim's expense. By acquiring adequate identifying information about a person, a criminal can take over that individual's identity to commit a wide range of crimes. This may involve false applications for credit cards and loans, fraudulent bank account withdrawals, and obtaining goods and services that the perpetrators would probably be denied were they to use their real names.

Financial Statement Schemes

Financial statement schemes are divided into two subcategories: financial and non-financial. Revenue overstatement is the most common financial statement fraud scheme. Miracles on the balance sheet and income statement can be produced by a simple credit to revenue and debit to account receivables. In some cases, companies simply create revenues and receive the desired benefits.

Timing Differences (Incorrect Treatment of Sales)

A timing differences scheme might be committed through several means to exaggerate profits for the current financial period. One strategy is to push excess inventory to salespeople or the distribution service in order that the inventory might be taken as a sale, knowing that most of it will be returned but during a later period. This technique is called channel stuffing. Sales may also be categorized in other violations of generally accepted accounting principles (GAAP), e.g. early revenue recognition.

For example, a three-year contract to provide services over the period might be considered as income in the current year to inflate profits for the subsequent set of financials, at a cost to future financials, clearly in violation of GAAP and the corresponding principle.

Fictitious Revenues

Recording sales that never occurred is also a fraud and is known as fictitious revenue. This can be based on real or fake clients. The outcomes are increased revenues, profits and, largely, assets, on the other side of the false accounting entry.

Concealed Liabilities (Inappropriate Recording of Liabilities)

This fraud is committed by a simple delay in the recording of liabilities during the twelfth month of the financial year, resulting in the current year having less expenditure, and recording those liabilities in the first month of the next financial year. Precisely because of the possibility of this fraud, financial auditors carry out subsequent-period substantive tests and look for invoices dated the year under audit but posted in the first month of the following year.

This fraud can also be committed by moving such liabilities to other places. In large companies with subsidiaries, this goal can be achieved by moving the liability to the subsidiary that is either not audited or perhaps audited by a different audit firm (a deliberate decision to hide the fraud). Companies are likely to use this scheme often.

Improper Asset Valuation

Improper asset valuation fraud can be committed by manipulating the financials to show a higher than actual profit and equity by inflating the asset amounts (commonly inventory, receivables, and long-lived assets), by capitalizing expenses, or by deflating contradictory accounts (allowance for doubtful accounts, amortization, depreciation).

Keys to Effective Fraud Investigation

The principles of forensic accounting are best described by a brief synopsis of a fraud investigation. In terms of organizational fraud, the purpose is to establish whether a fraud has been committed or is occurring and to establish the identity of the fraudster. In the legal process, the objective is decided by the client. A fraud investigation is initiated by a predication. Predication is the set of conditions that will guide the reasonable, prudent and professionally trained individual to believe that a fraud has occurred, is occurring, or will occur in the future. However, in litigation support, predication is initiated by a lawyer.

If there is limited information on the fraud, or if the exact fraud is not known, the next step is the fraud theory approach. Using this approach, a brainstorming session will probably lead the forensic accountant to propose the most probable fraud scheme, if it is not known already, and the way in which that fraud scheme may have been performed on the victim organization. This latter sub-step is often essential even during litigation support. The forensic accountant needs to be familiar with various fraud schemes and associated red flags for each scheme.

A fraud investigation plan might then be developed with the help of this theory. Based on the fraud theory, the forensic accountant devises a plan to collect adequate and competent evidence, such as forensic evidence. During this step, an examination is made of accounting transactions, records, documents, and data (if applicable) to acquire adequate evidence to ascertain whether the fraud identified earlier actually occurred. Important issues include the custody of evidence and several other legal issues.

The last step in the course of the investigation is to approach the suspect, which might occur accidentally or intentionally. The intentional approach is usually easy to avoid, but the accidental approach requires some additional effort. Should the auditor come across an irregularity in accounting transactions and documents, or other proof of something wrong, or a red flag linked with known frauds, or a violation of internal controls, before approaching someone for clarification he/she should first establish the likelihood of the reason for the irregularity not being fraud. The reason for this restraint is that when an auditor finds evidence of a fraud accidentally, he/she may approach the responsible party and ask for an explanation of this irregularity. At this point, the investigation becomes severely damaged and it becomes very difficult to obtain a confession or conviction in court.

An internal auditor, when examining performance reports, may notice that expenses are precisely twice the budget; this is classified as an anomaly, i.e. something that should not be.

The natural response is to go to the person in charge of sanctioning cheques in that business

unit and ask for clarification. However, if the relevant individual has been using an authorized maker fraud scheme together with forged endorsement, he may be writing two checks for each invoice, one for the dealer and one for the fraudster, in order to make a false endorsement and convert it to cash. If the auditor does approach that person, he/she will either produce a justifiable excuse or the auditor may unintentionally offer one.

In an actual case, the auditor suggested that the vendor must have been paid twice and the fraudster agreed. The fraudster was then given the chance to replace the misappropriated funds and avoided being apprehended. Had the auditor not discussed this, he might have been able to gather the evidence to establish whether it was actually an error or a fraud. By discussing the matter with the fraudster, the auditor provided her with an undetectable strategy to exit from the investigation. In other cases, fraudsters who have been confronted accidentally have unexpectedly retired, burned down the business building, destroyed accounting records, or taken other measures to destroy any evidence of the fraud.

After collecting accounting evidence, a forensic accountant will try to gather evidence from eyewitnesses during interviews. This interview process starts with people who are not involved but are possibly informed about the fraud, moving to a continuously narrowing circle of people who have direct knowledge of fraud; finally, an interview with the suspect is conducted. Throughout this process, extreme care should be taken to ensure that the suspect is not aware of the fact that a fraud investigation is in process until the forensic accountant is perfectly confident that he/she has obtained all the required forensic evidence to prove that a crime has been committed.

To conclude, the forensic accountant writes up the findings in a report to the party that appointed him/her. Should the case go to court, this report, or a similar one, may be needed during the trial. Nevertheless, should the case go to trial, the forensic accountant's work will have to be presented in an effective way to the judge or jury.

Further Reading:

- ✓ *Manning, G. A. (2005) Financial Investigation and Forensic Accounting, 2nd ed.*
- ✓ *Silverstone, H., Sheetz, M. (2006) Forensic Accounting and Fraud Investigation for Non-Experts, 2nd ed.*