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## Ways of corporate fraud risk minimization

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### Abstract

The article describes the most common types of corporate fraud, which include misappropriation of property, corruption and fraud with financial reporting. The article represents the negative financial, psychological and reputational consequences of corporate fraud risks. The dynamics of corporate economic crimes in Russia and in the world is analysed. The global damage from illegal actions of employees of management and operational level is estimated. The authors of the article describe the typical features of a corporate fraudster and the key reasons for inducing fraudulent actions. The article also analyses the advantages of Russian and worldwide practice of countering corporate fraud risks and proposes an integrated approach to solving the problem based on a combination of internal control mechanisms and corporate culture.

### For citation

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### Keywords

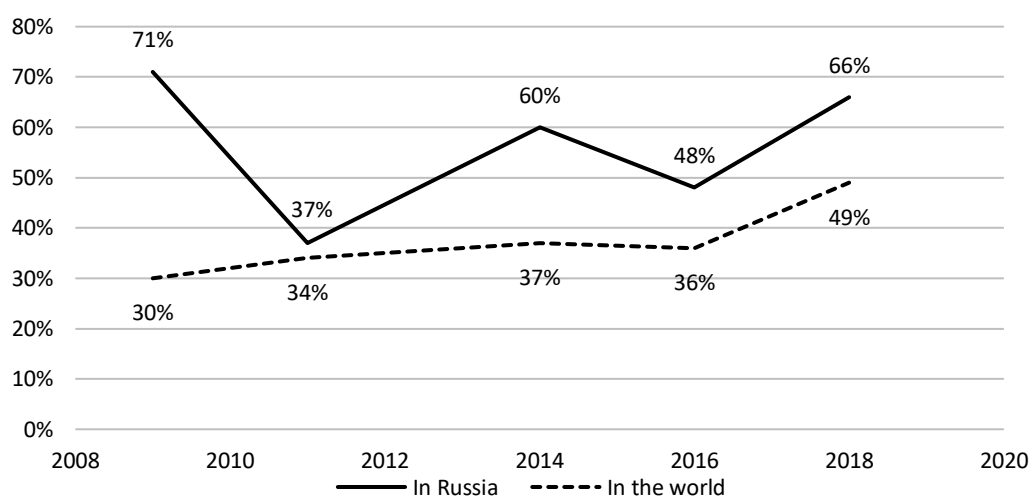
Corporate fraud, shadow economy, misappropriation of property, corruption, financial statement fraud, internal audit and control, forensic.

## Introduction

In 2017, the Strategy of economic security of the Russian Federation for the period up to 2030 was updated, where one of the key threats of the shadow economy is considered. The size of shadow economy depends on different approaches of estimating and varies from 13% of GDP according to the Federal state statistics service of the Russian Federation [PБК, 2019, www] and up to 40% of GDP according to investigation of the Association of Chartered Certified Accountants [PБК, 2017, www]. Moreover, corporate fraud is an integral part of the shadow economy and it is included in the category of ‘white collar’, which differs from other types of shadow economy in which it involves respectable people who hold high managerial and executive positions [Avdiyskiy, Dadalko, Sinyavskiy, 2018, 59]. Despite the rapid development of such anti-fraud tools as internal control and audit, forensic, monitoring of illegal actions, there is a significant increase in fraudulent activities both in Russia and all over the world. Therefore, the issue of countering and preventing the increase of corporate fraud risks is relevant and needs more in-depth research.

## Main part

Every year, both in Russia and around the world, the number of corporate economic crimes is growing. Thus, according to PwC research, 66% of Russian companies faced the phenomenon of economic crimes during the period 2017-2018, and the global figure for the period under review was 49%, that is 17% lower than in Russia (Fig. 1) [PwC, 2019, www].



**Figure 1 - Dynamics of corporate economic crimes, PwC**

The concept *fraud* is enshrined in the Criminal Code of the Russian Federation in article 159 and is stated as «theft of another's property or acquisition of the right to another's property by deception or abuse of trust». The term *corporate fraud* is not enshrined at the legislative level, according to the Association of Certified Fraud Examiners (ACFE) study, this phenomenon can be decomposed into three aggregated categories: misappropriation of property (89% of identified cases), corruption (38% of identified cases), and financial reporting fraud (10% of identified cases). However, the average financial losses from these types of fraud have an inverse relationship: misappropriation of property amounted to \$114,000, corruption amounted to \$250,000, and financial statement fraud amounted to

\$800,000 [ACFE, 2019, [www](#)].

The results of the ACFE study, which considered 2,690 fraud cases in 125 countries and 23 industries, also show: 1) total losses – \$7 billion; 2) the average amount of losses per case – \$130,000; 3) small business on average loses almost twice as much – \$200,000; 4) the most common fraudulent scheme is corruption; 5) the average implementation period of a fraudulent scheme is 16 months; 6) the most corrupt sector of the economy is energy. However, from all the detected cases of fraud, only 4% of perpetrators had a prior fraud conviction. A majority of the victims recovered nothing. And the top conspicuous facts in the identified corruption cases are as follows: life beyond one's means (43%), unusually close connection with a vendor or a customer (34%), financial difficulties (23%), fraudulent inclinations (21%).

As of 2018, on a global scale, the portrait of a typical corporate fraudster has the following averaged characteristics (by the number of fraud cases detected): male, 36-45 years old, having higher education and experiencing financial difficulties in life; an ordinary employee or middle manager working in the company for 1-5 years who has not previously been subjected to disciplinary or criminal liability.

As the results of the investigation show, Eastern Europe and Central-Western Asia, including Russia, are characterized by the prevalence of corruption fraud schemes – 60% of the detected cases in the region; the second place is occupied by criminal acts related to noncash – 30%; and the third place is occupied by billing – 15%. The total number of identified cases was 86, and the average amount of losses amounted \$150,000. Moreover, all actors of economic activity – from an ordinary employee to the owner – act almost equally as subjects of fraudulent violations, but a large share of funds is illegally appropriated by the company's owners and top management – \$3,700,000 and \$155,000 respectively [ACFE, 2019, [www](#)].

The losses of financial and tangible assets are significant and large-scale, but they are not the only consequence of the fraud risks implementation. Moreover, the cost of conducting investigations could more than double the amount of direct damage from the implementation of fraudulent risk. But it should not underestimate their negative impact on the efficiency of operational activities, as well as on the moral and psychological climate in the organization and its reputation. According to PwC, both in Russia and all over the world, the negative consequences of economic crimes primarily affect the morale of employees, business relations and relationships with regulatory authorities. This fact means that corporate fraud disrupts trust as a diligent counterparty in current market conditions [PwC, 2019, [www](#)].

The increases in the number of corporate financial crimes, as well as their negative consequences on the activities of organizations, actualize the need to study the ways and mechanisms of detection and prevention of fraudulent activities. However, in order to properly build a risk management, internal audit and forensic systems for corporate fraud, it is necessary to consider the causes of its occurrence [Skipin, Bystrova, Kuttyreva, Trufanova, 2017, [www](#)].

The corporate fraud problem is significant in the overall set of organizational risks of doing business due to the scale of its negative consequences, which take both material and intangible nature. The paradox of this phenomenon is that the source of the main threat is a human factor, one of the key resources of business development. There are three main reasons that encourage employees to commit criminal acts within the company: pressure, opportunity and justification. These factors are called the angles of the 'fraud triangle': pressure (motive) of external circumstances caused by a variety of reasons that a person is not able to overcome; favorable opportunity for some time to implement and hide fraud, using income for personal purposes (ineffective internal control, low labor discipline, indifference to what is happening on the part of management); justification of fraud, for example, a difficult life

situation [PwC, 2019, www].

Disclosure of corporate crimes is often caused by accident and external audit, rather than systematic actions aimed at identifying these offenses, since the internal economic security service checks are carried out formally. Not all tips to further investigations come through hotlines. When a reporting mechanism is not used, whistleblowers are most likely to report to: direct supervisor – 32%; executive supervisor – 15%; fraud investigation team – 13%; coworker – 12%; internal audit – 10% [ACFE, 2019, www].

A weak control system or lack thereof encourages employees to commit economic crimes. One of the main reasons for corporate fraud is the ability to commit this illegal act with impunity, that is, the internal control system is poorly developed [Altukhova, Mogila, 2018, www]. In this regard, the corporate culture that has developed in the team is of great importance, as it establishes standards of conduct: what is permissible and what is not. To combat corporate fraud, it is important to identify in which atmosphere there is a possibility of fraudulent transactions within the company. The marked step should be established both for suppression, and for prevention of fraud violations.

There are many actions and instruments of countering corporate fraud to identify it in a timely manner. Consider some aspects of the Russian and world practice in combating economic crimes against business, including corporate fraud [PwC, 2019, www] (Table 1).

**Table 1 - Comparison of approaches to combating corporate fraud**

<b>In Russia</b>	<b>In the world</b>
establishing economic security service; developing a set of measures aimed not at minimizing the risk of threats, but at eliminating them; creating corporate control aimed at eliminating losses related to fraud	shaping perfect corporate culture; developing measures aimed at early detecting fraud risks and creating effective internal control system; investigating fraud facts and minimizing consequences from implementation of fraudulent actions

Many domestic companies increase the cost of combating fraud, but this does not solve the problem dramatically and, as a result, opportunities for offenses remain open. Worldwide practice focuses on fraud prevention through the creation of a ‘collective spirit’. Moreover, it is important to understand clearly what measures to prevent economic crimes are aimed at: eliminating the motive, possibility or justification of corporate fraud. It should be noted that the key target of Russian practice is eliminating the possibility of the corporate fraud while the target of the world practice is eliminating the justification of it.

However, it is impossible to deal with the problem of corporate fraud alone. Currently, there is an increasing need in the efficient integrated system approach, which should include both an internal control and favorable corporate culture. Internal control mechanisms consist of internal audit, suspicious activity monitoring, physical and information corporate security, data analytics, staff rotation, etc. And corporate culture tools deal with communication from an external or internal source and a hotline for confidential information [Gordilov, Shklyayeva, 2019, www]. Employees should not only be held financially responsible for the identified violations, but also should realize a moral assessment of their actions in relation to colleagues and the company.

Moreover, when building a system to counter corporate fraud, it is necessary that it meets two criteria: necessity and sufficiency. Building and maintaining such a system should not cost more than implementing potential fraud risks [Kakovkina, 2018, 87]. It is also worth remembering that a large company, unlike a small one, can afford a separate economic security service, since in a small enterprise

it is expensive and impractical (i.e. it does not meet the two above mentioned criteria).

Against the background of a variety of fraud types, neither a department nor an employee in the company can take full responsibility for the detection and prevention of criminal acts. The interaction of specialists from the Risk-management, the Compliance Department, the Ethics Committee, the Legal Department and possible attraction of external Forensic-consultants will help organizations form a corporate culture that will serve as an efficient integral component of preventing economic wrongdoing, including corporate fraud.

## Conclusion

Thus, the analysis of the corporate fraud problem showed that its scale in Russia is much higher than the global indicator. Corporate fraud also largely actualizes the issues of the shadow economy, as it is part of its specific 'white collar' type in which, in many respects, the main role in the implementation of criminal economic activity is played by representatives of Operational and Executive positions. It should be also mentioned that among the most common types of economic crimes in business are assets misappropriation, corruption and financial reporting fraud. Besides, male persons are more prone to fraudulent actions in the company who are from 36 up to 45 years old and with experience in this company for more than 6 years. The consequences of fraud in business are primarily measured by financial losses. However, we should not lose sight of their negative impact on the corporate moral and psychological climate, business relations and image of the company. There are three key reasons that encourage the implementation of criminal actions within the company: motive, opportunity and justification. The Russian practice of countering corporate fraud focuses on reducing opportunities through highly effective internal control, and the world practice is aimed at eliminating justification forming an impeccable corporate culture. But none of the above practices can solve the problem alone, so a new integrated approach that effectively combines both internal control mechanisms and corporate culture to counter corporate fraud is needed.

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## **Способы минимизации риска корпоративного мошенничества**

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### **Аннотация**

В статье рассматриваются наиболее распространенные типы корпоративного мошенничества, к которым относятся незаконное присвоение имущества, коррупция и мошенничество с финансовой отчетностью. Статья описывает негативные финансовые, психологические и репутационные последствия реализации рисков корпоративного мошенничества. Анализируется динамика корпоративных экономических преступлений в России и в мире. Оценивается совокупный мировой ущерб от противоправных действий сотрудников управленческого и операционного звена. Авторы статьи описывают портрет корпоративного мошенника и ключевые причины, побуждающие к мошенническим действиям. Анализируются преимущества российской и мировой практики противодействия рискам корпоративного мошенничества, а также предлагается интегральный подход к решению проблемы, основанный на сочетании механизмов внутреннего контроля и корпоративной культуры.

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### **Ключевые слова**

Корпоративное мошенничество, теневая экономика, незаконное присвоение имущества, коррупция, мошенничество с финансовой отчетностью, внутренний аудит и контроль, форензик.

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