

CORRUPTION AND FRAUD IN PRIVATE SECTOR

Borisas Seminogovas

*Kaunas University of Technology, Faculty of Economics and Management,
Laisvės al. 55, LT-44309 Kaunas, Lithuania
Email: Borisas.Seminogovas@ktu.lt*

Abstract. Analysis of numerous publications clearly indicates that the importance of corruption and fraud problems is becoming extremely important worldwide. The main objective of the research was to compare different approaches of professionals while dealing with corruption – external and internal auditors and certified fraud examiners. Detailed analysis of approaches and their further comparison indicated that the approach of certified fraud examiners is more flexible and promising. The main advantage is that certified fraud examiners clearly recognise corruption in the private sector as a separate type of fraud with its specific features and consequent practical implications. This analysis was supplemented by qualitative research done by interviewing top managers of Lithuanian companies. Results show that these problems in Lithuania are very similar to other countries. The main differences are extreme awareness of top managers, actuality of problems for smaller companies and a pragmatic view on possible solutions for them.

Keywords: fraud, corruption, private sector, fraudulent activities, auditing, auditors, examiners.

Jel classification: M42, M14, M49.

1. Introduction

Now it is widely recognised that the issue of corruption in the private sector is of great importance. During the last ten years corruption in the private sector has been discussed in numerous information sources (ACFE 2012; EC 2012; OECD 2010; OECD 2011; TI 2009; E&Y 2012a; E&Y 2012b; E&Y 2012c; CIPE 2011; Olsen 2010; IIA 2012b; UN 2009). During the same period there were attempts to implement different measures directed against corruption in the private sector on an international or national level (Council of the European Union 2003; UN 2004; AS 2008). For example, Lithuania has already adopted the whole basic set of legislation related to corruption in public and private sectors (LR 2002; LR 2003 LR 2008; LR 2010; LR 2011). On the other hand, during early implementation it became clear that more deep research of the phenomenon is required, especially in applied areas.

Main research done in this field is mostly oriented towards developing and improving the definition of corruption in the private sector and legal aspects, for

example, on different aspects of civil law or criminal law including criminalisation. Quite comprehensive research of legal aspects of corruption has also been done in Lithuania (Burda 2012; Gavelis 2010).

Analysis of different sources in the field shows an existing tendency of recognition of corruption in private sector as a separate type of fraud (ACFE 2012). This approach has been mostly developed by practitioners dealing with corruption, for example, by fraud investigators or examiners. Issue of fraud is traditionally important in professional activities of internal and external auditors, but fraud was limited to areas of fraudulent financial reporting and misappropriation of assets. In the author's opinion, the structure of fraud, as it is recognised by auditors, should be expanded and requires additional research, especially in the area of necessary changes in regulation of professional activities of internal and external auditors.

The main objective of this paper is to compare approaches to corruption in the private sector by different professionals and indicate difficulties experienced by them while dealing with this problem.

It is widely recognised that corruption in the private sector has two dimensions. The first dimension is connected to transactions between private and public sectors. The second dimension is connected to transactions between private companies. In current research only the second dimension is introduced.

The research was based on the following methodology. During the first stage comparative analysis of the professional activities of external auditors, internal auditors and certified fraud examiners in area of corruption was performed. On the basis of analysis main differences in their approaches were identified. During the next stage these findings were checked by research of corruption in Lithuanian private sector on the basis of qualitative interview of top managers.

2. Practical implications of definitions of corruption in the private sector and fraud for activities of external and internal auditors

For the context of this research it is important to understand how issues of corruption in the private sector are presented in external and internal auditing standards, which determine main objectives of activities for both types of auditors. For this purpose it is necessary to compare definitions of corruption used in standards with the widely accepted definition.

The most widely accepted and possibly the most comprehensive definition of corruption from a legal point of view, including its active and passive forms, was done in article 2 of Council Framework Decision 2003/568/JHA of 22 July 2003 on dealing with corruption in the private sector (Council of the European Union 2003). This definition is also important as it should be directly transferred and implemented in national law of EU member states. Active corruption in the private sector was defined as “promising, offering or giving, directly or through an intermediary, to a person who in any capacity directs or works for a private sector entity an undue advantage of any kind, for that person or for a third party, in order that

that person should perform or refrain from performing any act, in breach of that person's duties". Correspondingly passive corruption in private sector is defined as "directly or through an intermediary, requesting or receiving an undue advantage of any kind, or accepting the promise of such an advantage, for oneself or for a third party, while in any capacity directing or working for a private-sector entity, in order to perform or refrain from performing any act, in breach of one's duties".

In case of standards of internal and external auditors there is no definition of corruption applied. Both sets of standards are operating with fraud only. Therefore a wide definition of fraud is used. Because of this some authors stated that fraud and corruption are the same.

Considering International standards on auditing (ISA) there is no special definition of corruption and the term corruption in ISA is used only once in presentation of practical issues of application ISA 220 "Quality Control for an Audit of Financial Statements" (IFAC 2012). Orientation of ISA is quite narrow, as the main task of auditors is to identify material misstatements, including those which arise from fraud. On the other hand definition of fraud in ISA 240 "The auditor's responsibilities relating to fraud in an audit of financial statements" is extremely wide and is overlapping even the above presented definition of active and passive corruption done by EC. In ISA 240 fraud is defined as "an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage." (IFAC 2012). The fraud in ISA context is limited to two types of fraud – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets (IFAC 2012).

There are three objectives of the external auditor in the area of fraud as presented in ISA: "(a) To identify and assess the risks of material misstatement of the financial statements due to fraud; (b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and (c) To respond appropriately to fraud or suspected fraud identified during the audit" (IFAC 2012).

International standards for the professional practice of internal auditing of the Institute of Internal Auditors applied a quite similar approach (IIA 2012a). There is also a wide definition of fraud as "any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage." On the other hand, as involvement of internal auditors in all areas of the company operations is much higher than of external auditors fraud issues are presented more often through standards, particularly in Performance and Implementation groups of standards (IIA 2012a).

The main objective of internal auditors in area of fraud is defined by implementation standard 2120.A2, which is clearly presented "the internal audit activity must evaluate the potential for the occurrence of fraud and how the organization

manages fraud risk” and by performance standard 2060 “Reporting to Senior Management and the Board” (IIA 2012a). It is also important, that there is a preset limitation on possible knowledge and expertise of internal auditors in area of risk of fraud (Implementation standard 1210.A2).

It could be concluded that at current stage of development standards of external and internal auditors deal exceptionally with fraud and not specifically with corruption. Both sets of standards apply extremely wide definitions of fraud which are overlapping the definition of corruption. Therefore, there are certain responsibilities of external and internal auditors in areas of detection and reporting of issues of corruption in private sector (Khan 2006; Mudugu *et al.* 2012). On the other hand, such situations confirm the current position of auditors that the phenomenon of corruption in the private sector does not require special standard settings and general approaches applied to fraud are suitable and applicable for corruption also.

In general, it could be concluded that such traditionalism resulting in a rigid and inflexible position is not in line with the dynamics of problems associated with corruption in the private sector. A possible explanation for this is the fact that any changes in auditing standards, especially of external auditors, is an extremely complicated and long lasting process, taking sometimes many years to finish.

3. Approach to corruption and fraud in the private sector applied by certified fraud examiners

The approach applied to corruption in the private sector significantly differs from the approach applied by auditors (ACFE 2012). At first glance the definition of corruption schemes proposed by certified fraud examiners is quite similar to others, as the same important points are stressed: “...Corruption schemes, in which an employee misuses his or her influence in a business transaction in a way that violates his or her duty to the employer in order to gain a direct or indirect benefit (e.g., schemes involving bribery or conflicts of interest).” The main difference of approaches is that certified fraud examiners in their fraud classification present corruption as a third type of fraud alongside asset misappropriation and financial statement fraud.

In general classification of occupational fraud corruption it is presented not only as a third type of fraud together with two types traditionally recognised by auditors, but with allocation certain schemes of fraud as distinguished features of corruption. Exclusively to corruption such schemes are allocated as conflicts of interest, including purchasing and sales schemes, bribery, including invoice kickbacks and bid rigging, illegal gratuities and economic extortion (ACFE 2012).

Of course such classification could raise further discussion and critics considering its underlying scientific background, but without doubt it should be recognised as a significant step forward in methodology of corruption research and has tremendous practical implications because of its advantages.

4. The research of corruption in Lithuanian private sector

Research was done by an informal qualitative interview of 27 top managers of Lithuanian private companies of different size and industries during a three year period. It cannot be evaluated as statistically valid and representing and could be evaluated as an initial base for planning of further more detailed research, but certainly enables to make some preliminary conclusions on the topic.

All top managers that were interviewed indicated awareness of corruption in their own company in conjunction with relations with other private companies. In their opinion their companies are more likely to be targeted by active corruption.

Procurement process was indicated as a process with the highest degree of corruption risk. Traditionally, it is presented that corruption in this field is mainly an attribute of big companies, but interviews of Lithuanian top managers show that corruption in procurement also exists in middle and small companies.

In their opinion the risk of corruption in procurement appears immediately as the company grows to a certain size and procurement is separated in structure with delegated power from top management. This structure is targeted by active corruption from other private companies seeking advantages and trying to distort competition.

There are numerous means of corruption in this area, for example kickbacks, gifts irregular by size with regular business practice, compensation of trips and others. Sometimes it is extremely difficult to separate such activities from regular business practice. For example, it is quite popular to visit a few places where equipment proposed for procurement by vendor is already installed and is in operation. Another example is selection of a certain supplier from range of suppliers with a product of similar quality or price. Even comprehensive and structured procurement processes established by companies could be easily overridden by means of corruption. In some cases or on some stage it is not possible even to measure losses which such activities bring to the company. Not all facts of private corruption have any documental traces and not all corruption activities may result in or lead to material misstatements on the level of financial reports. Private businesses prefer to not publically announce corruption cases inside the company believing that it will harm their reputation. This practice is similar to practice in many other countries.

In fact all top managers of companies with separated procurement are suspecting that such type of corruption exists in their companies and think that the best possible solution is to keep it to certain level. They do not believe that there is one measure which when applied is possible to solve corruption problems.

Another process indicated as having a high risk of corruption is sales process.

Corruption in the private sector usually requires a deeper understanding of business of audited company than it is described in appropriate ISAs, therefore external auditors are not seen as effective in solving corruption problems.

Implementation of an internal auditing function is more promising but in opinion of top managers is very costly and that is why it is not popular. The most effective way is combination of development of clear processes with some control measures built-in, for example screening, and working with personnel, especially in areas of recruiting and motivation.

It could be concluded that problems of corruption in the private sector in Lithuania at a qualitative level are quite similar to other EU countries (EC 2012). The main differences are in big awareness, actuality of problem for smaller companies and a very pragmatic view on possible solutions of the problem.

5. Conclusions

Comparison of different approaches considering problems of corruption in the private sector shows that the current position of external and internal auditors is too rigid. Corruption in the private sector is seen by auditors as fraud and is still not separated as a totally different type of fraud with its specific features. In general this fact creates practical implications for the work of external and internal auditors and it is why their methodology is lagging behind.

The most promising approach to the problem of corruption in private sector is developed by certified fraud examiners. This approach does not yet include sound scientific background but certainly has advantages. Corruption is clearly recognised as totally different type of fraud with specific features.

Even limited qualitative research enables to conclude that problems of corruption in private sector in Lithuania at qualitative level are quite similar to other EU countries. The main differences are huge awareness, actuality of corruption problem for smaller companies, which differ from the traditional and widely distributed opinion, and a very pragmatic view on possible solutions of the problem and outcomes.

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Boriss SEMINOGOVAS is an Associate Professor at Department of Accounting, Faculty of Economics and Management, Kaunas University of Technology and member of Lithuanian Chamber of Auditors. His research is focused on Internal and External Auditing.