

FRAUD BETWEEN DEFINITION AND WAYS TO DEFRAUD ILLUSTRATED BY EXAMPLES

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Abstract: Auditors have a key role in the formulation of an opinion on the effective functioning of management and control systems of the operational programs co-financed by ESIF. International Auditing Standards states that the primary responsibility for preventing and detecting fraud lies with both top management and those responsible for governance of the entity. On the other hand, the auditors also play a role in the fight against fraud and should help Member States fulfill their obligations to prevent, detect and correct irregularities and fraud.

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1. INTRODUCTION

In 2012, OLAF (European Anti-Fraud Office) has established a collaboration procedure with E.U. Member States for the exchange of experience and good practice between Member States and the European Commission. This procedure is carried out within the COCOLAF Group for fraud prevention. The procedure consists of a working group composed of experts from Member States and representatives of OLAF, Regional and Urban Policy General Directorate, Employment, Social Affairs and Inclusion General Directorate, Maritime Affairs and Fisheries General Directorate. They work for a year on a specific topic chosen by the Member States.

EU legislation is a framework for the activity of audit authorities in ESIF domain. This makes a clear reference to international auditing standards, which provide guidance on the role of auditors in fraud prevention and detection.

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On the other hand, the auditors also play a role in the fight against fraud and should help Member States to fulfill their obligations to prevent, detect and correct irregularities and fraud.

Audit authorities of the Member States bear the responsibility, stipulated in their professional status, for two main types of audit: system audit and audit of operations. These two types of audit have different fields of interest and, therefore, prevention and detection of potential fraud will be examined separately.

The purpose of continuous improvement is to assist auditors in enriching their theoretical and practical knowledge necessary for identifying where to invest time and resources so as to contribute more effectively to combat fraud. Best practices presented in the manual by the experts of Member States should contribute to achieving this objective.

As in many other fields, training is essential for achieving efficiently and effectively the tasks. This provides an initial set of theoretical and practical knowledge, based on fundamental principles. Also, auditors can update their knowledge and maintain a high level of performance and knowledge through continuous training. Auditors need specific training directly related to their role in combating fraud. Thus, real cases and situations should be used.

2. DEFINITIONS

The audit is generally a systematic process of obtaining and evaluating objectively information or statements in order to assess their degree of compliance with pre-established criteria, as well as the communication of results to interested users. (AAA) Audit consists of a set of interconnected tasks (a process) carried out by the auditors or by other experts who, based on their theoretical and practical knowledge and after assignments from specific organisms, analyze the information and operations of an entity or related to certain activities in order to provide assurance through the formulation of opinions or recommendations (Oprean, 2002).

A broad definition of corruption used by the Commission is the abuse of a public position for private purposes. Corrupt payments (bribery) facilitate many other types of fraud, such as false invoicing, phantom expenditure or failure to meet contract specifications. The most common form of corruption is bribery or offering other advantages; the receiver accepts a bribe from a donor (active bribery) in exchange for a favor.

The convention, drawn up under Article K.3 of the Treaty on European Union, on the protection of the financial interests of the European Communities (Official Journal of the European Communities, 1995), defines "fraud", in terms of cost, as any act or deliberate omission related to:

- ✓ using or presenting false, incorrect or incomplete statements or documents, which results in misappropriation or improper retention of funds from the general budget of the European Communities or the budgets managed by or on behalf of the European Communities;

- ✓ nondisclosure of information and violation of a specific obligation, with the same effect;

- ✓ the misuse of such funds for purposes other than those for which they were originally granted.

ACFE divides fraud into three types, as a starting point for an organization to identify areas vulnerable to fraud:

1. Intentional manipulation of financial statements (e.g. incorrect reporting of revenue)
2. Any type of misappropriation of tangible or intangible assets (e.g. fraudulent expense reimbursements)

3. Corruption (e.g. bribery, manipulation of bidding procedures, undeclared conflicts of interest, misappropriation of funds).

There are three elements that underpin committing fraud, which can be summarized as a "fraud triangle" (Harry Cendrowski, James P. Martin and Louis W. Petro, 2007):



opportunity – chance

rationalization – justification

financial pressure – financial burden

Opportunity: Even if a person has a reason, there must be an opportunity. Inefficient internal control systems may create an opportunity (*the presumed likelihood of fraud not being detected is a crucial consideration for the fraudster*). Examples of weaknesses in internal control systems are the deficiencies concerning:

- supervision and review;
- separation of functions;
- approval by the governing bodies;
- control of systems.

Fraud can also occur if controls are not performed or persons of authority create opportunities to override existing controls.

Justification: A person can formulate a justification by reasonably explaining their acts, e.g. "it is fair to do this - I deserve this money" or "they owe me", "I'm just borrowing the money - I will return them."

Financial pressure, inducement or motivation: „need or greed” factor. Pure greed can often be a strong reason. Other pressure can arise from personal financial problems or personal vices such as gambling or drug addiction etc.

"Breaking the fraud triangle" (Harry Cendrowski, James P. Martin and Louis W. Petro, 2007) is key to fraud prevention. Of the three elements, opportunity is most directly affected by strong internal control systems and therefore is the most manageable.

3. THE FACILITATING FACTORS OF FRAUD

Factors that generate and favor the tax evasion phenomenon, both in its "permitted" and not sanctioned by law form and the one sanctioned by the law, may be grouped, for a better systematization, in:

✓ **psychosocial factors**, relating both to the inner impulses and beliefs of the taxpayer and the general conduct and social environment to which he belongs;

✓ **economic factors**, related to the taxpayer's perception of the level of income remaining after payment of taxes and its ability to meet the individual needs of the taxpayer;

✓ legal and administrative factors, related, on the one hand, to the perception of how the taxes are decided, the equity of tax system and the perception regarding the destinations chosen by the government for the revenue collected from taxes, and, on the other hand, to the taxpayer's perception on how the state institutions apply tax laws and any penalties arising from failure to comply with them.

All these factors have a combined action on the decision to avoid taxation, so drawing a clear line of each person's action is both difficult and inappropriate.

Therefore, we believe that the recourse of a taxpayer to tax evasion, or not, is an internal option, personal to each taxpayer, which is in correlation with his perception on some exogenous variables, taken as a whole.

4.LEGAL ASPECTS REGARDING FRAUD AT INTERNATIONAL LEVEL

Tax evasion is the logical result of the flaws and inconsistencies of an imperfect legislation, faulty methods of application and the incompetence of legislature, whose excessive taxation, for example, can be considered as guilty as those it provokes thereby to evasion.

According to the author, Vasile Bîrle (Birla, V., 2003), in the modern world, tax evasion has become a phenomenon, even a scourge in many countries, which grinds the economy, devours it from the roots, stifling it without giving any hope .

We believe that regardless of how it is defined this phenomenon; tax evasion is, finally, the failure to pay tax obligations, in bad faith, by the taxpayers.

The most common method of legal tax evasion is the existence of *tax havens*.

The name of tax haven tends to be replaced today with that of international financial center or financial paradise due to the numerous benefits granted to foreign investors in several domains, not just the taxation. Tax havens' aim is to attract foreign investors, who, benefiting of large facilities granted by these countries, will invest huge financial resources in certain business which will bring substantial benefits to the level of the country, thereby ensuring its development.

According to the opinion of C. Corduneanu a tax haven is "an instrument through which the international tax evasion is made by taxpayers seeking a more advantageous tax treatment", in other words a lower tax rate. In the opinion of Grigore Lăcrița, the fiscal paradise is a country or a geographical area with an almost non-existent tax regime and a high degree of fiscal discretion or an area where tax obligations can be suppressed in full legality and almost impossible to control.

4.1.TAX HEAVENS/FISCAL PARADISE

For a territory to be considered a tax haven it must present several common characteristics: confidentiality, protection of financial or trade transactions and distribution of goods, financial systems without restrictive regulations, lack of control of trade exchange operations or financial transactions which, in some countries, are strictly regulated and therefore monitored and controlled; and it needs a flawless system of communication. (Safta, M.,1999).

André Beauchamp, in his book "Guide mondial des paradis fiseaux", organizes the major tax havens in relation to the existing tax regime in the following six groups:

- countries where income and capital growth of individuals is not taxable (Bahamas, Bermuda, Monaco, Cayman Islands);
- countries where the corporation tax is determined on a territorial basis, taxpayers benefiting from a tax exemption for profits from transactions completed

outside the territory (Costa Rica, Hong Kong, Malaysia, Panama, the Philippines, Venezuela);

- Countries that offer specific benefits to holding companies (Luxembourg, Singapore.)

- countries that offer tax exemptions for investments created to increase exports (Ireland for the companies created before 1981);

- Other countries that offer specific advantages to certain companies (Jamaica, Barbados).

Besides the main tax havens, there are countries that have relaxed tax systems or offer exempts and tax cuts to attract foreign investors and increase exports: Virgin Islands, Jamaica, Taiwan, Switzerland, USA, France, and Belgium etc.

5.METHODS AND FAMOUS CASES OF FRAUD ENCOUNTERED IN THE BUSINESS WORLD

Frauds can be divided into different categories depending on the chosen criteria. Thus, from the corporate point of view the frauds can be committed by corporations and against corporations.

Financial frauds can be grouped into four categories, namely:

- ✚ fraudulent financial reporting systems;
- ✚ spoliation of assets;
- ✚ income and assets obtained by fraud;
- ✚ expenses and liabilities related to improper purposes.

The number of international companies that have reported incidents of fraud increased by 22% over the past two years, according a study conducted by the first 4 audit companies in the world.

Although there were implemented new procedures to control fraud by the corporations, fraud is still widespread, difficult to be prevented and, in terms of its detection, it is due more to luck - as stated by a study of Price-Waterhouse-Coopers based on interviews with a number of 3000 subjects from 34 countries.

Frauds were found in 45% of the companies included in this survey, with 23% more than in 2003, according to data provided by Reuters. In the case of North American companies, it was discovered that those who carried out the frauds were employees of those companies in a percentage of 60% and, out of that percentage, 25% belonged to the top management.

In 2003 SEC accused the company Anika Therapeutics of improper recognition of some revenues in value of USD 1.5 million, representing merchandise. One dealer issued orders to Anika for 15 000 units of a particular product in April and July 1998. As part of the agreement with this distributor, Anika billed for these 15 000 units with more than 500 000 USD in September 1998 but the products remained in Anika deposits until May 1999, and Anika included these sales in the financial reporting from 30 September 1998.

Besides the premature revenue recognition, other methods were applied when these revenues were recorded on the basis of fictitious sales or nonexistent customers. Boston Japan, a supplier of medical equipment, recorded sales of USD 75 million in the period 1997-1998 from fraudulent sales - the company's sales managers leased commercial deposits, recorded false sales to distributors and delivered cargo to rented warehouses. The company has concealed that distributors have never paid those assets by issuing invoices by reversing to those and then recording other sales of the same goods to other distributors, but without moving the goods from the rented warehouses.

Company employees even recorded sales to distributors not involved in the field of medical equipment, but who had agreed with the company's sales executives to be part of this fraud.

Another method is to record transactions that occur between companies but in the end they present no economic benefit for any of the companies. For example, if a company gives a customer a loan so he can buy company's products, it is part of such a scheme if the loan was given for never being repaid. These transactions have the sole aim of increasing sales revenues.

5.1. PARMALAT BANKRUPTCY

Parmalat (Wikipedia, Parmalat) was the greatest Italian food company and the fourth largest in Europe, controlling 50% of the Italian market for milk and milk products. Suddenly, it was discovered that it lacked liquidities in the amount of 4 million Euros and 8 million in securities, so investors' money had vanished. Parmalat bankruptcy represented 1.5% of the Gross National Italian, so by keeping the proportions this was bigger than World Com and Enron bankruptcies combined.

The images of large agro industrial company with 34 000 employees hide a huge speculative financial scheme aiming to attract investors' money and divert them through a network of 260 offshore companies, where the money evaporated. It was found that a Cayman Islands offshore entity, called Bonlat, has invested USD 6.9 billion in derivative securities with a high degree of financial risk. In this way, through such schemes, have disappeared at least 8 billion Euros.

It all began in 1997 when Parmalat decided to become a global player and began a campaign of international acquisitions, especially in North and South America, all of which were funded by loans. Thus, Parmalat soon became the third largest company in the United States in terms of production of cookies. But these purchases, instead of bringing profits have started bringing losses from 2001.

Parmalat founder Calisto Tanzi has involved the company in some unusual actions such as purchasing the Parmatour travel agency and Parma football club. Large sums of money were pumped in these two businesses, which from the beginning registered only losses. It was found that a loss of at least 2 billion Euros was recorded at Parmatour, a particularly high amount for a travel agency.(www.parmalat.com)

Losses of the football club are not yet known. Moreover, there have been some allegations of links with the Medellin cartel - overestimated acquisitions of Colombian soccer players. While accumulating losses, alongside increased bank debt, Parmalat began to build a network of offshore companies based in mailboxes in order to hide losses by presenting them as assets or liquidities, while the company began to issue bonds to raise money.

The law company called Robbins, owned by Zini in New York, played a role in this story that seems cut from The Godfather. Through Zini, Parmalat-owned companies were sold to American citizens of Italian origin, after which they were again acquired by Parmalat. This whole operation was a fake: money for the first sale came from other entities owned by Parmalat and was intended to create liquidities in the financial statements. Due to these high liquidities Parmalat could continue to issue bonds. Former CEO Tanzi told Parma prosecutors that the whole system was fully the banks' idea.

Parmalat crisis broke out on December 8, 2003, when the company could not pay maturing bonds worth 150 million Euros. Management of the company blamed for

this situation one customer, a hedge fund called Epicurum, which did not pay its obligations. It was assumed that Parmalat had obtained substantial income from a contract with derivatives concluded with Epicurum. But recently it has been found that Epicurum was owned by a company whose address coincided with the address of offshore companies owned by Parmalat, in other words Epicurum belonged to Parmalat. (Crime Investigation Magazine, 2011)

On December 9, as the rumors on the insolvency of Parmalat spread around, Standard & Poor's downgraded Parmalat bonds permanently and Parmalat shares on the Stock Exchange fell by 40% the following days. On December 12, Parmalat management somehow found the amount needed to pay the bonds but Bank of America announced on December 19 that the sum of 3.9 billion USD, assumed to be in Parmalat accounts, really did not exist. Suddenly bankruptcy was obvious and shares dropped by 66%. Tonzi later admitted that he forged Bank of America documents using a scanner, scissors and glue, and thus fabricating an account of USD 3.9 billion.

On December 22, 2003 the Italian government promulgated a law allowing rapid procedures for Parmalat bankruptcy to protect its industry. Enrico Bondi was instructed by the government to submit a reorganization plan until January 20, 2004. However, Bondi, who had replaced Tanzi few days before, in addition to the commission received from the Government, was also the man who had received from banks the task to reorganize the Ferruzzi - Montedison Group. The concern that Bondi will promote banks' plan to divide Parmalat and then sell it piece by piece was shared by the union and the Government.

In Italy there were about 100 000 Parmalat bondholders, most of them families who were counseled by banks to buy these securities which virtually mean nothing nowadays. In the same year Italy has also recorded two other bankruptcies that hit Italian investors, amounting to 13.2 million euro in total. Red thread of this catastrophe unfortunately leads to banks. Italian banks attracted their customers - workers, retired persons - with high-risk investments, and in most cases they did not know that their money was invested at risk or in the best case they knew they were in safe investments

In October 2005 Parmalat was again listed on the Milan Stock Exchange.

6. CONCLUSIONS

Auditors have a key role in the formulation of an opinion on the effective functioning of management and control systems of the operational programs co-financed by ESIF. International Auditing Standards states that the primary responsibility for preventing and detecting fraud lies with both top management and those responsible for governance of the entity.

Audit authorities of the Member States bear the responsibility, stipulated in their professional status, for two main types of audit: system audit and audit of operations. These two types of audit have different fields of interest and, therefore, prevention and detection of potential fraud will be examined separately.

Propensity to tax evasion exists in every individual from whom the governmental authority takes some of the income that belongs to him by law, and therefore he perceives this, first and foremost, as an attack on his welfare and freedom to enjoy the fruits of his labor. A rational individual aware of his own capabilities, but also of the shortness of life (especially of the active part of it) can not give up easily on what he thinks he deserves for some public purpose that is not always understood by him, or, in any case, is irrelevant to him.

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The purpose of continuous improvement is to assist auditors in developing their theoretical and practical knowledge necessary to identify where to invest time and resources so that to contribute more effectively to combating fraud. Best practices presented in the manual by experts from the Member States should contribute to this objective.

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