AMOGHVARTA
ISSN : 2583-3189

Corporate Fraud and Investor's Interest: A Critical Analysis

ORIGINAL ARTICLE

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Abstract

Corporate frauds committed by corporations are a major problem all around the world, not just in India. As a result of corporate fraud and corruption, several large businesses around the globe have gone down in flames over the previous three decades. India's corporate market is no exception to this phenomenon. It is described as an activity done in against the corporate governance norms. It causes a rise in unemployment, a drop in tax revenue, and general economic instability. It adversely impacts not only the economy but also its stakeholders. Keeping corporations free of malfeasance is essential for safeguarding the interests of shareholders. The author in this research paper elucidates the concept of corporate fraud by discussing a few significant cases. An inter-relation between corporate fraud and investor protection will be examined by the author. The author further suggests certain changes to deal with the issue of corporate fraud in an effective manner.

Key Words

Corporate frauds, Government norms, malfeasance, Shareholders, Economic stability.

Introduction

Misrepresentation of information, alteration of financial books and records, concealment of debt, hiring of fictitious personnel, creation of fictitious financial documents, exposure of price sensitive information, etc. are all examples of corporate fraud. Corporate fraud adversely impacts the interest of investors whereas the security market would not exist without investors. Considering the forgoing statements, the importance of investor protection is significant. Investors risk their hard-earned monies in the hopes of a return on their investment. If their faith is damaged by corporate frauds, it will have a negative effect on the economy. They will be hesitant to invest in the financial market any further. Fraud in the business world can be prevented by several different regulatory agencies. There are numerous laws and regulations in place to safeguard investors' capital.

Corporate fraud is a multifaceted phenomenon that encompasses a range of deceptive activities employed by individuals/group of individuals within or associated with a company. The corporate fraud includes wide range of activities, these activities may include financial misrepresentation, embezzlement, insider trading, bribery, and other illicit schemes aimed at manipulating financial information, deceiving stakeholders, and unlawfully benefiting a select few. The motivations for engaging in corporate fraud are diverse, often rooted in the pursuit of financial gain, personal enrichment, or the desire to maintain an illusion of corporate success.

Corporate Fraud: Meaning and Nature

The contribution of corporations to the expansion of the Indian economy is crucial. Businesses in India are the backbone of the country's economy. The number of registered firms and the total amount of paid-up capital in India's corporate sector have both grown significantly over the past two decades. The corporate sector has been given a boost by the central Government's adoption of several reform measures.[1] Nonetheless, despite these efforts, corporate fraud remains a significant threat to the economy of the Nation by hampering the growth and prosperity of businesses in the country. The very definition of fraud is, an act of dishonesty with the goal of obtaining something illegally or depriving someone of something they are legally entitled to. Victims of fraud may suffer immediate and long-term financial losses and emotional and physical distress. In this context, "corporate fraud" refers to any dishonest or unethical behavior on the part of a business or an employee while conducting business on the business's behalf. Complex fraud related incidents are notoriously difficult to uncover. This can be achieved in several ways, including by ad hoc criminal activity, bribery, embezzlement, counterfeiting, forging, tax evasion, professional criminal activity, fraud, etc.[2] The trust of corporate investors could be shattered by corporate fraud. If investors' interests aren't safeguarded, they can look other than the securities market for opportunities to make a profit. The consequences of laxity in the security of the market and business world will be severe and catastrophic. The market will be in shambles and have repercussions throughout the country. Yet, in the last twenty years or more, corporate fraud has grown into a major problem. International and national societies are increasingly worried about how to combat this growing problem of corporate fraud. Every country, whether rich or poor, has experienced some kind of corporate fraud and so with the case of India. It has repercussions not just for the corporation and its constituents, but for the national economy as well.

Meaning and Nature of Corporate Fraud

Fraud is the intentional misrepresentation of, or failure to disclose, a material fact in order to cause another person to take an action that is detrimental to them. Intentional concealment of material truth, misrepresentation or careless misrepresentation is also a form of intentional fraud that causes another person to act against his or her best interests. Hence, "corporate fraud" describes unethical or illegal actions conducted by a business or people. Typically, the goal of this type of fraud in business is to benefit the perpetrator. Complexity and monetary impact on the company, or upon other fellow employees, as well as outside parties are hallmarks of corporate fraud schemes that go beyond an employee's declared role. In this context, "corporate fraud" refers to any type of deception perpetrated by a company or its top officials. The following are examples of what it could consist of "cooking the books" in accounting; fraudulent transfers of company assets; illegal or fictitious borrowings to the company and syphoning by a business leader; fraudulent transfers of company assets; bogus purchases and other fraud; intentionally erroneous financial reports; phony tax returns; bribery and corruption; phony credentials for employment; payroll and suspense accounting fraud, etc.[3] Theft of money, property, or sensitive information is only one type of corporate fraud. Other types of fraud, such as those involving procurement, payroll, improper journal vouchers, suspense accounting, false employment credentials, bribery and corruption, etc., fall under this category as well.[4] Different corporate scams might occur for different reasons at different times. There is no unifying theory that can account for all instances of fraud in the business world. Corporations cannot survive or function normally when fraud is committed against them. Both internal and external audits are typically used to uncover business malfeasance. The Income Tax division can also investigate corporate fraud by looking through accounting records. Company fraud can also be uncovered by the board of directors, and especially by the company's independent directors. It can be divided into following categories:[5]

1. **Financial Fraud:** Financial frauds include, but are not limited to, the following: account manipulation and falsification; tampering with accounting records; misrepresenting or omitting amounts; incorrectly

applying accounting principles; submitting intentionally false accounting statements; providing misleading information; omitting material information; etc.

Fraudulent activities may occur when individuals in powerful positions within a company abuse their authority for personal gain. This can include self-dealing, nepotism, or other conflicts of interest.

2. **Misappropriation of Assets:** Theft of physical assets, sale of confidential information, improper payments, etc. fall under the umbrella term of "misappropriation of assets", which can be committed by both insiders and outsiders.

   Misappropriation of assets is a common form of corporate fraud wherein individuals within an organization unlawfully divert company resources for personal gain or benefit. This type of fraud involves the unauthorized use, theft, or misuse of company funds, inventory, equipment, intellectual property, or other assets. It can occur at various levels within an organization, from low-level employees to top executives, and can have significant financial and reputational consequences.

   One of the most prevalent forms of misappropriation of assets is embezzlement, where employees or executives misuse company funds entrusted to them for personal expenses, such as luxury purchases, vacations, or gambling. Embezzlers often use sophisticated schemes to conceal their actions, such as falsifying financial records or creating fictitious vendors or employees to siphon funds unnoticed.

   Another common form of misappropriation involves the theft or misuse of inventory or equipment. Employees may steal goods from warehouses or retail stores, manipulate inventory records, or use company equipment for personal projects without authorization. These actions can result in significant financial losses for the company and disrupt its operations.

   Misappropriation of intellectual property is also a concern for many corporations. Employees or contractors may unlawfully use or disclose proprietary information, trade secrets, or copyrighted material for personal gain or to benefit competitors. This can result in lost competitive advantage, compromised product integrity, and legal liabilities for the company.

3. **Corruption:** Corruption refers to acts like making or accepting illegal payments; bribing public or private authorities; accepting bribes; assisting and abetting fraud; etc.

   Corporate corruption refers to unethical or illegal practices carried out within the realm of business organizations, often to gain unfair advantages, maximize profits, or conceal wrongdoing. It encompasses a wide range of behaviors, including bribery, embezzlement, fraud, insider trading, and collusion, among others. This form of corruption undermines trust in institutions, distorts market dynamics, and erodes the social fabric of communities.

One of the primary drivers of corporate corruption is the relentless pursuit of profit at any cost. In competitive markets, companies may resort to underhanded tactics to gain an edge over rivals or inflate their financial performance to attract investors. This pressure to deliver results can create a culture where ethical considerations are sidelined in favor of short-term gains.

Corporate Fraud Cases in India: A Practical Outlook

When a business or other organization alters or omits key facts with the intent to create a false impression of financial health, this is known as corporate fraud. Some examples of business fraud include providing misleading information in a prospectus, tampering with financial documents, failing to disclose debts, and concealing assets. Yet, the following are examples of business corruption and fraud in India:

(A) Fraud by German Auto Company Volkswagen[6]

German Automobile Manufacturer Volkswagen Volkswagen's diesel automobiles in India were equipped with a "cheat device" in September 2015, despite the company's claims that the vehicles produced minimal emissions. The "National Green Tribunal" ('NGT') concludes that manufacturers use of deception devices constitutes prima facie evidence of environmental damage. An emission test "cheat" or "defeat device" is software installed on diesel vehicles with the express purpose of altering the vehicle's worldwide performance for the purpose of passing the test. There have been about 13.25 million automobile recalls in India. In addition, the NGT has ordered the German automaker to put up an interim sum of 100 crore with "the Central Pollution Control Board".

(B) Satyam Scandal[7]

On January 7th, 2009, the company's founding chairman, B. Ramalinga Raju, wrote a letter to the Board of Directors in which he confessed to the fraud. He inflated the company's finances by Rs.7,855 crores by inflating revenue, margins, and cash balances. The corporation lied about its financials to its stock exchanges, board, regulators, investors, and everyone else who might have an interest in the company. It was a scam that spread false information about the financial strength of the company which hurt its reputation. Operating profits, revenues, intertest obligations, and cash reserves were all inflated to give the impression that the company was doing well when in reality they were in dire straits. Whether or not external auditors did a good job of ensuring there were no financial irregularities is open to debate. From at least 2002, the firm has been manipulating data, initially with little numbers that have now grown into much larger ones. The Raju brothers, however, were found guilty of various offences including conspiracy, breach of trust, cheating, and document falsification, and were consequently sentenced to prison.

(C) The Kingfisher Airlines scandal[8]

The chairman of UB Groups Vijay Mallya was charged with being a "willful defaulter" and other crimes in the wake of the airline's demise in November 2015. In March of 2016, a syndicate of sixteen banks lead by SB1 petitioned the Supreme Court to restrict Mallya from departing from India due to his owing them approximately Rs. 9000 crores in debt. A group of Indian banks lead by the State Bank of India accused Vijay Mallya of fraud, criminal conspiracy, money laundering, and diverting loan funds, and he owed them over 10,000/- crore in defaulted loans[9]. Some of his businesses, including Kingfisher Airlines, have been accused of breaking the Companies Act of 2013 and financial markets regulations. The CBI has filed charges against Mallya under the provisions of "The Prevention of Corruption Act", and "Sections 120B and 420 of the Indian Penal Code of 1860". Mallya was designated a "Fugitive Economic Offender" by a special court in Mumbai in January. This designation was made under the "Fugitive Economic Offenders Act, 2018". In December 2016, ED seized Rs. 9661 crores worth of Vijay Mallya and Kingfisher assets in India.

(D) ICICI Banks Scam

Whistleblower Arvind Gupta had called for an investigation into the "illicit banking and commercial relationship" between Venugopal Dhoot's Videocon Group and the family-owned NuPower Renewable Group, which is led by Chanda Kochhar's husband Deepak Kochhar. This revelation led to the Rs. 3250 crores ICICI bank scam coming to light. In 2010, the spouse of Chanda Kochhar received Rs 64 crore from Dhoot, according to the allegation. After receiving Rs 9 lakh from Deepak Kochhar's trust, it is claimed that Dhoot sold the company's ownership to the trust. The loan from ICICI Bank came in at Rs 3,250/- crore, and he received it six months after the occurrence. ICICI Bank and its former CEO Chanda Kochhar were served with notifications by SEBI in 2018 seeking responses to allegations of non-compliance with the erstwhile "Listing Agreement" and "the Listing Obligations and Disclosure Requirements Regulations, 2015". Nevertheless, Chanda Kochhar failed to mention that her husband, Deepak Kochhar, had business dealings with Videocon while she served on the company's loan sanctioning committee. As a result of the probe, she had to resign as CEO of ICICI in 2018. She and her spouse had always steadfastly denied the allegations. On January 30, 2019, a case related to the matter was opened by the central investigation agency. As a result of the case registration by the Central Bureau of Investigation (CB) on January 22, 2019, an investigation into Deepak Kochhar, Chanda Kochhar, Venugopal Dhoot, and their associated companies has begun.

(E) Harshad Mehta Scam[10]

In 1992, Indian stock trader Harshad Mehta was implicated in a controversy. Mehta engaged in widespread fraud in the Indian stock market. It caused the entire security infrastructure to fail. The amount of money he stole from the banking system and used to buy equities was well over a billion dollars. Mehta influenced the Sensex to rise from a little over 1,000 points in April 1991 to about 4,500 points in April 1992.[11] The resulting Rs. 4,000 crores in fraudulent gains is enormous. A group of stockholders led by Harshad Mehta received the monies that had been stolen from the banks. A total of Rs. 1,700 crores ($266 million) has been stolen from 4 different banks through his cunning schemes.

Corporate Fraud and Investors Protection

Investors form an important asset to any corporation. They are essential to the functioning of any firm and should not be overlooked. Protection for investors in the securities market refers to measures taken to safeguard financial capital. Investors protection covers a wide variety of situations. It safeguards investors against corporate fraud and other forms of financial misbehavior. Investors need to be shielded from corporate crimes like fraud and misconduct. As a matter of fact, investors come from diverse backgrounds. It’s possible that some of them are well-educated, wealthy, and knowledgeable about the trade, investment, and share market, while others are poorly educated, low-income, and clueless. Nonetheless, all shareholders need safeguards against wrongdoing by corporations. Investors faith in the security markets must be safeguarded. Market capitalization would suffer severely if this were not the case. When investors’ confidence is low, they are less likely to put their money into the market. The process of collecting the necessary funds will be laborious and challenging. In light of this, the Government of India has implemented a number of safeguards designed to protect the interests of such investors. By comparing “Corporate fraud” and “investors protection”, we observe that they have a negative correlation with one another. The greater the prevalence of corporate fraud, the weaker the protection for investors. If corporate fraud and corruption rise, interest of investors become more vulnerable.

The interface between the corporation and its investors are governed through legislative framework, for instance Companies Act of 2013; regulatory bodies such as SEBI and RBI; and institutions such as Stock Exchanges. However, amongst these, SEBI plays a significant role in protection of interest of investors. SEBI’s mission includes looking out for the best interests of investors. The SEBI has taken several steps to safeguard investor assets. Among these are periodic issuance of guidelines; public interest advertisements; resolution of investor complaints and grievances; investor education; investor surveys; and disclosure requirements for companies, among others[12]. To further safeguard investors interests, SEBI has also moved to register and monitor the business’s intermediaries, including bankers, transfer agents, trustees, brokers, registers, portfolio managers, merchant bankers, etc. To further ensure the safety of its clients, SEBI maintains a vigilant watch for any securities market-related scams or unfair trading practices. But despite these attempts, the issue of corporate crime has worsened significantly. In light of ever-increasing issue of corporate fraud, we have the Section 211 of Companies Act of 2013 which provides for “Serious Fraud Investigating Office” to take proper measures against such corporate crimes[13].

In addition to SEBI, the Government has established an “Investor Education and Protection Fund”[14] (‘IEPF’) under “Section 125 of the Companies Act of 2013”, pursuant to which the company transfers the unclaimed monies in an account to accumulate dividends, matured debentures and deposits, share application money, etc. to the IEPF after seven years. Such unclaimed monies are mandatorily to be transferred into the said fund by the Government. The amount collected in the said fund is then further utilized to create investor education awareness program which is aimed at educating and safeguarding such investors.

Additionally, an effective corporate governance has potential to reduce the prevalence of corporate fraud while maintaining a sound vigilance to eliminate the commission of any corporate fraud[15]. Hence, we can say that corporate governance is crucial for an uninterrupted expansion of businesses and the economic well-being of nations. A successful adoption and execution of corporate governance contributes immensely in protecting the interest of investors.

Conclusion

In our society every person is distinct from others. Some are genuine and ethical whilst others might not be the same. Similarly, a corporation comprises of varied nature of employees. Wherein, some employees might be ethical, others might not be same. In this regard, corporate fraud is one corporate crime which adversely affects the interest of investors of the corporation. To limit and prevent corruption and fraudulent activities in a corporation, stringent rules and regulations have to be formulated and robust mechanisms for their orderly execution should be implemented and enforced. A surgical strategy can duly be employed to combat fraud and corruption. The components which make a typical anti-fraud plan includes identifying fraudulent activity; preventing fraud; discouraging fraudulent activity, and reaction to fraud.[16] Fraud can be averted through building a solid ethical practices and thorough sound eternal control systems.

Fraud detection is a crucial aspect to prevent fraud unless fraud is caught it could never be averted. As a result, a system must be put in place internally to identify instances of fraud. Different warning indicators, for instance, financial risks signals, business threats signals and IT and Data threats signals may be added. As a fraud detection approach, a fraud alert method should be introduced. For instance, if any disparity is found between lifestyle and earnings or if photocopies documents are maintained instead of originals and so forth hence a fraud signal should be sent.[17] In addition to fraud detection measure, trend analysis, continual risk assessment, data matching etc. may very well be implemented.

The fraud action plan of the organization must be robust and holistically complied with. The company's fraud policy and fraud response strategy should elaborate on how the organization intends to handle fraud. Fraud deterrent policy adopted by the company often develops a dread psycosis inside the minds of those who are engaged in fraud. Included in the company's fraud response plan should be the company's firm intent to cope with the fraud, the company's investigation policy, and the firm's firm response.

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