

Financial Crimes Auditing

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Abstract—Criminal activities generate significant illegal money and need to launder this money so that they can be integrated into the legitimate financial system. Economic and financial crimes that called white-collar crimes, typically has diffuse costs to society and concentrated benefits for the perpetrators. The social expectations are that the auditors should play an effective role in reducing, if not eliminating, these crimes. New auditing standards require auditors to take a proactive approach to assessing whether management has in place appropriate systems and controls to manage the risk of fraud. Also the UK government has introduced legislation that requires accountants and auditors (and other financial advisers) to play a central role in the detection/reporting of fraud and money laundering. This legislation expects accountants and auditors to override their commercial concerns and report suspicious transactions and schemes to regulators. This paper shed light on nature, impacts and types of economic and financial crimes, and then the role of auditing profession in fighting against them.

Index Terms—Economic and financial crimes, money-laundering, Auditing profession.

I. INTRODUCTION

Economic and financial crimes can include a wide range of activities from fraud through to active manipulation of the stock market or laundering of the proceeds of crime (ACC, 2011). The modern globalised economy and new technologies create new opportunities for organized crime to exploit vulnerabilities for profit (ACC, 2011). While there seems to be broad agreement on the meaning of such concepts as money laundering, corruption, and tax evasion, the terms financial abuse and financial crime are far less precise, and in fact are sometimes used interchangeably. Financial abuse has the broadest meaning, encompassing not only illegal activities that may harm financial systems, but also other activities that exploit the tax and regulatory frameworks with undesirable results. Financial crime, which is a subset of financial abuse, can refer to any non-violent crime that generally results in a financial loss, including financial fraud. It also includes a range of illegal activities such as money laundering and tax evasion (IMF, 2001).

II. NATURE OF ECONOMIC AND FINANCIAL CRIMES

Economic and financial crimes comprise a broad range of illegal activities, including fraud, tax evasion and money-

laundering (United Nations, 2005). The concept of financial crime, as such, is not new. However, the ways in which financial crime is being committed are changing and (Srinivas, 2005) rapid advances in technology, provide new opportunities for such crimes (United Nations, 2005). In general, financial crime can refer to any non-violent crimes that result in a financial gain to the perpetrators and loss to others or the state (Rashid, 2007). The Financial Services and Markets Act (FSMA) defines financial crime "to include any offence involving (a) fraud or dishonesty; (b) misconduct in, or misuse of information relating to, a financial market; or (c) handling the proceeds of crime". The use of the term "to include" means that this is not an exhaustive list and that Financial Services and Markets Act (FSMA) can be interpreted widely to include bribery and corruption (FSA, 2010). Financial crimes or financial frauds can be classified as white-collar crimes, which represent the illegal acts that are characterized by deceit, concealment, or violation of trust. Financial crimes are not dependent upon the application or threat of physical force or violence but can result in a substantial financial loss to the customers or to a bank (Srinivas, 2005).

III. IMPACTS OF ECONOMIC AND FINANCIAL CRIMES

Economic and financial crimes represent a dangerous form of criminal behavior that affects not only individual member of a society but also having deleterious effects on the economic, health and material welfare of the community as a whole. Financial system abuse has potentially negative consequences for a country's macroeconomic performance, imposing welfare losses, and may also have negative cross border negative externalities (IMF,2001). These financial criminals create significant risks for institutions' reputations. Moreover, their activities have a variety of regulatory compliance implications (Bernard and Williams, 2004). May also distort the allocation of resources and the distribution of wealth and can be costly to detect and eradicate (IMF, 2001). There are other negative macroeconomic consequences. For example, it could compromise bank soundness with potentially large fiscal liabilities, lessen the ability to attract foreign investment, and increase the volatility of money flows and exchange rates (Rashid, 2007). Individual citizens also suffer the effects of serious financial crime. Some market frauds have taken in thousands of people, many of whom lose their savings, security and may have their emotional well-being, physical health and relationships affected (ACC, 2011).

IV. TYPES OF ECONOMIC AND FINANCIAL CRIMES

The term "economic and financial crime" refers broadly to any non-violent crimes that result in a financial loss.

Manuscript received december 9, 2011; revised february 10, 2012.

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These crimes thus comprise a broad range of illegal activities, including fraud, tax evasion, money-laundering and etc. The category of “economic crime” is hard to define and its exact conceptualization remains a challenge; but most prominent economic and financial crimes are as follow:

A. Corruption

A common definition of public corruption is the misuse of public office for private gain. Misuse, of course, typically involves applying a legal standard. Corruption defined this way would capture, for example, the sale of government property by government officials, kickbacks in public procurement, bribery and embezzlement of government funds (Svensson, 2005). In other words a situation where private persons or public officials abuse their position by, for example, paying or accepting bribes from a firm or by embezzling funds, to make personal gain (FSA, 2010) or for the benefit of a group to which one owes allegiance (Rashid, 2007). Corruption is an outcome a reflection of a country’s legal, economic, cultural and political institutions (Djankov & et al, 2003). Most anticorruption programs rely on legal and financial institutions judiciary, police and financial auditors—to enforce and strengthen accountability in the public sector (Svensson, 2005).

B. Tax Evasion

Tax evasion is also an old problem. people don’t want to pay taxes if they find a way to do so. Tax evasion is defined as an illegal act to avoid paying taxes by violating tax laws (Akdede, 2006). Tax evasion is a big fiscal problem: large amounts of taxes go unpaid, and even more would not be paid were it not for auditing. Remaining outside the tax net, non-disclosure of actual income, non- payment of income tax, underhand agreement with the tax authority, gross abuse of the tax holiday provisions may be mentioned under this category. The provision of payment of a low rate of tax that legalizes any income without a need to declare source has been considered and criticized as a crime-friendly environment. Purchase of property and investments in the capital market may also be done without declaring the source of income. Under-invoicing of dutiable imports also deprives the government from the due revenues (Rashid, 2007).

C. Capital Flight

Unlike most concepts in economics, capital flight is not clearly defined by economic theory. Capital flight is often defined as an illegal transaction which occurs when traders keep capital abroad by the falsification of trade documents. Capital flight can be transacted by deliberately underinvoicing exports and/or overinvoicing imports. Confining the definition of capital flight in this way is very restrictive as it ascribes the occurrence of capital flight to one channel (trade) and, as a consequence, only to one group of traders. Capital flight can also be transacted through several other channels such as cash movements or smuggling of goods, antiques, precious gems, gold, silver and other precious metals (Schneider, 2003), use black market money exchange to transfer money, front companies to retain portions of export proceeds, overseas accounts to get commissions, kickbacks and bribes (Rashid, 2007). Although there is no generally accepted definition of capital

flight, the literature has postulated three major reasons for its existence: (a) investment, (b) money laundering, and/or (c) tax evasion (Boyrie, 2010).

D. Smuggling

Underground economic activities exist in all countries. They are of two types. First, there are those that are illegal such as engaging in the drug trade or the smuggling business. The second consists of those activities that are legal but are not officially recorded to evade taxes or for some other reason (Myint, 2000). Organic Law 12/1995 of 12 December 1995 on the Repression of Smuggling define Smuggling as “import or export of legally tradable goods without submission for customs clearance at the offices or locations envisaged by the customs Administration and also the undertaking of trade transactions, possession or circulation of legally tradable non-Community goods without complying with legally established requirements to accredit their legal import and etc”.

E. Bank Fraud

According to Connell University Law School (CULS), bank fraud is defined as "whoever knowingly executes, or attempts to execute, a scheme or artifice (1) to defraud a financial institution; or (2) to obtain any of the moneys, funds, credits, assets, securities, or other property owned by, or under the custody or control of, a financial institution, by means of false or fraudulent pretenses, representations, or promises"(Rashid, 2007). Bank fraud includes credit card fraud, money laundering, and mortgage fraud (Ngai & et al, 2011). Credit card fraud is defined as the unauthorized usage of a card, unusual transaction behavior, or transactions on an inactive card (Syeda & et al, 2002). money laundering is the process by which criminals conceal or disguise the proceeds of their crimes or convert those proceeds into goods and services (FBI, 2007) and mortgage fraud is defined as “material misstatement, misrepresentation, or omission relating to the property or potential mortgage relied on by an underwriter or lender to fund, purchase or insure a loan” (Ngai & et al, 2011).

F. Insurance Fraud

Insurance fraud is a significant and costly problem for both policyholders and insurance companies in all sectors of the insurance industry. Insurance companies typically employ a claims investigation unit to investigate fraudulent activities. The investigation unit gathers supporting information to deny claims that are fraudulent, or to authorize payment to claims where there is insufficient supporting evidence to draw a fraud conclusion (Snider & Tam, 1996). Insurance fraud can occur at many points in the insurance process (e.g., application, eligibility, rating, billing, and claims), and can be committed by consumers, agents and brokers, insurance company employees, healthcare providers, and others (Ngai & et al, 2011).

G. Organized Crime

The traditional understanding is that organized crime or criminal organizations are entities controlled and operated by criminals for the common purpose of generating positive cash flows from illegal acts. Drug trafficking is a specific example of an organized criminal organization. The primary

difference is that these organizations specialize in trafficking narcotics for illegal sale in countries all over the world. Organizational crimes occur when public and private companies, nonprofits, and government entities, otherwise legitimate and law-abiding organizations are involved in a pattern of criminal activity. Corporate violations include administrative violations that involve noncompliance with agency, regulatory, and legal requirements (Kranacher, 2010).

H. Terrorism Financing

Because terrorism organizations need funds to operate and purchase guns, explosives, and other supplies; require training; and often function loosely or efficiently as organizations; fraud professionals and forensic accountants are integral to following and tracing their funding sources. The goal of fraud examiners and financial forensic professionals is to deny terrorist groups access to the international banking system. This has the affect of impairing their ability to raise funds, thus exposing, isolating, and incapacitating their financial networks (Kranacher, 2010).

I. Pyramid Schemes

In a pyramid scheme, fees or dues are paid by new members to join the organization. The new member, upon joining, is expected to attract and sign up new members and collect their membership fees on behalf of the organization. The organization generates cash flow, not by selling goods and services to clientele but by the collection of membership fees from new members. The membership fees are then distributed in part to the old members as a form of return on investment (e.g., dividend) to keep the old members attracting new members and to keep the scheme from collapsing (Kranacher, 2010).

J. Financial Statement Fraud

Financial statement frauds (FSF) have received considerable attention from the public, the financial community and regulatory bodies because of several high profile frauds reported at large corporations such as Enron, Lucent, and WorldCom and Satam computers over the last few years (Apparao & et al, 2009). The most common species of financial statement fraud involves overstatements of assets, revenues and earnings, and/or understatement of costs and expenses – so as to inflate the profitability (or minimize the losses) of an entity (Dooley, 2002), and/or understating liabilities (Apparao & et al, 2009). Also accounting fraud Concoct books of accounts, making different books for different constituencies (tax authority, banks, shareholders, etc.), amalgamating personal and company/business financials, etc (Rashid, 2007). Detecting management fraud using normal audit procedures is a difficult task (Coglitore, and R. G. Berryman, 1988). First, there is a shortage of knowledge concerning the characteristics of management fraud. Second, most auditors lack the experience necessary to detect it. Finally, financial managers and accountants are deliberately trying to deceive the auditors (Fanning and Cogger, 1998).

V. MONEY LAUNDERING

Money generated in large volume by illegal activities must be laundered, or made to look legitimate, before it can be freely spent or invested; otherwise, it may be seized by law enforcement and forfeited to the government (OTA, 1995). In money laundering, the proceeds of crime are run through the financial system to disguise their illegal origins and make them appear to be legitimate funds (Scott, 1995). There are various definitions of the money laundering, but according to European Committee Manual for Money Laundering issued in 1990, money laundering consists in transferring ill-gotten money obtained through criminal activities and mixing it up with legal money with the aim of hiding the illegal source of this money and avoid the legal responsibility arising from the consequences of such an illegal action (Kenawy, 2006). Money laundering generally involves a series of multiple transactions used to disguise the source of financial assets so that those assets may be used without compromising the criminals who are seeking to use them (Mc Dowell, 2001). Disguise the origin and ownership of money, often by placing it in a bank, moving it through multiple transactions, and finally mixing it with legitimate funds. These steps are known respectively as placing, layering, and integrating the money. Money laundering associated with organized criminal activities, terrorism financing, money flows associated with drug trafficking, tax evasion, deliberate misrepresentation of an entity's financial performance, and deliberate bankruptcy misreporting. Violations arising from these schemes may include money laundering, corruption, tax fraud, financial statement fraud and etc. (OTA, 1995).

VI. RESPONSIBILITIES OF MANAGEMENT

It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of money laundering and terrorism financing activities rests with management through the implementation and continued operation of adequate accounting and internal control systems. Such control systems reduce but do not eliminate the possibility of money laundering and terrorism financing activities (SAP 19, 2006). New auditing standards (for example ISA 240/SAS 99), require auditors to take a proactive approach to assessing whether management has in place appropriate systems and controls to manage the risk of fraud.

VII. RESPONSIBILITIES OF AUDIT COMMITTEE

Corporate governance includes those oversight activities undertaken by the board of directors and audit committee to ensure the integrity of the financial reporting process (Public Oversight Board, 1993). Three monitoring mechanisms have been identified in the corporate governance literature. They are external auditing, internal auditing, and directorships (Anderson et al. 1993, Blue Ribbon Committee 1999) as well as the audit committee (Institute of Internal Auditors [IIA], 2003). An audit committee should take an active role in the prevention and

deterrence of fraud, as well as an effective ethics and compliance program. Most audit committees will also want to obtain information about all violations of the law and the organization's policies.

VIII. RESPONSIBILITIES OF AUDITING PROFESSION

Auditors can play a vital role in assisting the agencies responsible for investigation against alleged cases of corruption. The investigating agency could be an internal entity, some anti-corruption commission, police, judiciary or a specialized body for a mega corruption case. The auditors will need to come out of the cocoon of 'internal documentary evidence'. They would need to collect information from outside sources such as users of a public facility, client organizations, or even general public (Akram Khan, 2006). Internal auditors and external auditors can serve a vital role in aiding in fraud prevention and deterrence. Fraud can be discovered through many sources, namely, internal or external auditors, forensic accounting consultants, employees, vendors, and others (AICPA, 2005).

A. *Independent Auditors*

Clearly, external auditing serves as a monitoring mechanism to check on the accuracy of financial information, and to prevent and to discourage financial misappropriation (Kimbrow, 2002). Specifically, external auditing can be used to detect financial irregularities (de Paula & Attwood, 1976). For example, a finance director falsifying corporate financial statements can do so either to steal corporate cash-flow for her or his own pockets (individual crime), or to manipulate the tax bill in order to reduce corporate tax payments (organizational crime). Based on Hong Kong standard on auditing "an auditor and others have a statutory duty to take the initiative to disclose to an authorized officer (as defined in the Drug Trafficking (Recovery of Proceeds) Ordinance and the Organized and Serious Crimes Ordinance) knowledge or suspicion that property represents proceeds, of drug trafficking and indictable offence under section 25A of the Drug Trafficking (Recovery of Proceeds) Ordinance and the Organized and Serious Crimes Ordinance respectively'. (Hong Kong Standard on Auditing 240, paragraph No. 112). As auditors scrutinize client's books and should notice any irregularities in their business turnover, some may want to see auditors as the first line of defense against money laundering. Unfortunately, it seems that auditors conducting general audits are not looking for evidence of this type of crime it is outside the scope of general audits. None of these factors that undermine auditors reporting suspected cases to the authorities are insurmountable. Law makers may decide to protect auditing firms from being sued if they wrongfully accuse a client of money laundering, the efficiency of law enforcement can be improved to the point that auditors feel confident in reporting cases, and there may be merit in awarding auditing companies a monetary reward for successfully reporting an instance of money laundering, and so on. moreover, auditing firms have the potential to educate their clients in order to make it less easy to launder money through their business, which in turn limits their client's exposure to inadvertently laundering dirty money a

crime that could have disastrous consequences for the business involved (Standing & Vuuren, 2003). If it is known that money laundering or terrorism financing has occurred, the auditor need to consider the specific circumstances, including materiality, to assess whether the auditor's report should be modified (SAP19, 2006). The UK government has introduced legislation (e.g. the Criminal Justice Act 1993 and The Money-Laundering Regulations 1993) that requires accountants and auditors (and other financial advisers) to play a central role in the detection/reporting of fraud and money laundering. This legislation expects accountants and auditors to override their commercial concerns and report suspicious transactions and schemes to regulators.

B. *Internal Auditors*

Internal audit is an important part of the corporate governance structure within an organization. Traditionally the internal auditors were acting as 'policemen' that check and monitor the company's procedures and level of compliances with the rules (Skinner and Spira, 2003). It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes (IIA, 2004). In other words, the internal audit basically is to deal with fraud and red flags (Shamki, 2009). Several standards outline the role of the internal auditor in detecting, preventing, and monitoring fraud risks and addressing those risks in audits and investigations (Burnaby et al, 2009). Internal audit departments should form key lines of defense in the fight against bribery and corruption. It is good practice for their work schedules to include assurance work on the adequacy of underlying due diligence on third party relationships, as well as checks to ensure appropriate approval is sought to establish and maintain relationships and that there are good business cases for making third party payments (FSA, 2010).

C. *Forensic Accounting and Auditing*

Forensic accounting is a new branch in accounting/auditing which has the sole aim of unearthing fraudulent activities within and outside an organization so far as the third party's action is in any way reflective on the activities of that organization. Manning (2007) defines forensic accounting as the application of financial accounting and investigative skills to a standard acceptable by the courts to address issues in dispute in the context of civil and criminal litigation (Shamki, 2009). Forensic audits are conducted by an expert in the field to verify information, determine valuations, investigate fraud, verify compliance with government regulations, verify compliance with contracts, and to investigate and report on other issues. Forensic audits are done for the benefit of third parties and are documented so that they can be presented in a court of law (Minniti, 2008).

D. *Performance Audit*

It is generally understood that performance auditing can help detect corruption. A properly planned and executed performance audit would highlight areas of diseconomy, inefficiency and failure to achieve results and impact. Performance auditing can, however, provide some clue to

corruption if it exists. For this purpose, the performance auditors need to go a step deeper into the issues identified during the audit planning stage (Akram Khan, 2006).

IX. CONCLUSION

This paper has discussed the responsibilities of internal and external auditors in detection fraud as well as economic and financial crimes, and has stressed the importance of them in reporting as accurately as possible to facilitate audit committee and even authorities in detecting money laundering proceeds from them. For the reason that approximately all proceeds from illegal, Criminal and fraudulent activities need to be laundered, so fighting against money laundering can partly prevent this activity in economic and enhance trust in society. Since money laundering entails complex transactions through legal organization, banking systems, financial markets and etc, auditors with their skills can detect these transactions. This paper has also recommended performing forensic accounting and auditing as well as Performance auditing as a tool for finding economic and financial crimes in an organization.

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