CHAPTER 3
THEORETICAL FRAMEWORK

3.0 Introduction

Theoretical framework is a conceptual structure in the form of a visual aid or a document that is used to explain the concepts, key factors and variables used in the study and to represent the apparent relationship between the variables in the study (Miles and Huberman, 1994). Hence, this chapter introduces the fundamental concepts and theories underlying the present study, the conceptual model used, the different variables adopted and the relationship between them. Also, this chapter explains the interrelationship between independent variables impacting corporate frauds and governance practices of the organization.

3.1 Corporate Governance

In the present day CG seems to be the catchword in the world of business globally. Good governance is not only based on the legislation, but extends far into the outlook and managerial culture. Although the government and various regulatory bodies are introducing and enforcing the law, companies following the norms together with designing their own business ethics good CG still seems to be a flight of fancy as the norms and ethics are confined only to the papers mostly ensuing corporate frauds. CG in a broader sense can be described as a system of management practices that mainly focuses on aligning the interests of the investors and management in order to ensure that the firm is functioning appropriately for the benefit of the investors. In this study we consider CG as “A system of regulating and overseeing corporate conduct and of balancing the interests of all internal and external stakeholders who can be affected by the company’s conduct, in order to ensure responsible behaviour by
corporations and to achieve the maximum level of efficiency and profitability for corporations (DuPlessis, James & Mirko 2005, p.10). Apart from these factors, the role of the financial sector in CG has attracted plenty of discussions worldwide including in India.

Quite often, Anglo Saxon model and the continental model are used to discuss the role of the financial sector in the corporate environment. However, in this study, the author has implemented the conceptual model to depict the relationship between CG and corporate frauds.

3.2 Relationship between CG and corporate frauds

Year 2008 witnessed a major financial crisis globally, and the United States, United Kingdom and many other Asian countries were no exception to this. Consequently, there were closure of several multinational organizations, bankruptcy and acquisition of banks in various countries. Following this, in 2009 Satyam Computer Services Limited, India’s renowned IT services industry underwent a major corporate scam that left the global corporate community in aghast (Madan Lal Bhasin, 2013). Similar was the case with Enron Corporation, an American energy company which ultimately led to the bankruptcy of the company. Another instance of major corporate fraud was WorldCom, the third largest telecommunications company in the United States wherein the company confessed that its reports were fraudulent as the company was undergoing half a billion loss in reality, although it stated that the company was making a profit of $3 billion (Javiriyah Ashraf, 2011).

A detailed analysis of all the above and few other corporate frauds reveal that the principal cause of such downfall was due to lack of effective CG. Therefore the concept of good CG came into the limelight. Since banks are an essential part of a
countries’ economy, the failure of one bank can affect other banks thereby impinging on the entire financial system and the nation’s economy. Hence there is rising concern about the challenges faced by the financial institutions in terms of preventing corporate frauds and devising and implementing an effective CG strategy (Preethi, 2015).

3.3 Relevance of Conceptual Model in the Study

The CG model followed in India is partly based on the Anglo-Saxon model of CG. However the model has been customized to adapt to the Indian legal environment. For example, the issue concerning the US or UK central governance is “disciplining the management that has ceased to be effectively accountable to the owners who are dispersed shareholders. However, in contrast to these countries, the main issue of CG in India is that of disciplining the dominant shareholder who is the principal blockholder and of protecting the interests of the minority shareholders and other stakeholders”. Appending to this issue is the “weak enforcement of CG regulation through the Indian legal system” (IICA report).

However the Indian CG norms underwent many reforms of which Kumara Mangalam Birla Committee, Naresh Chandra Committee and Narayan Murthy Committee are noteworthy and similar to the England’s Cadbury Committee in terms of its recommendations. On the contrary, in the Anglo-Saxon model the focus of the governance is on capital markets, the control of corporate is separated from ownership, and its instability seems to contradict the Indian Scenario (Preethi, 2015).

Considering the above factors and the available studies pertaining to preventing corporate frauds with efficient CG strategies, the researcher has developed a unique model considering various other factors that have not been discussed in other studies.
3.4 Variables of the study

“Variable”, a term often used in qualitative research projects, refers to any quantity whose value can change. Variables of a research are used to predict the relationship between the two factors, comparison of the factors and identifying the factor which are most and least important. Among the different types of variables such as independent & dependent, active & attribute, continuous & discrete, extraneous and demographic variables, independent and dependent variables are widely used in most of the research projects. In this study, the researcher has selected the independent and dependent variables after stating the objectives and reviewing the literature.

The independent variables:

1. Sound Risk Management Framework
2. Data Management and analysis
3. Code of Conduct for Board of Directors
4. Internal & External control system
5. Forensic Accounting
6. Independent auditor’s role
7. Role of top management
8. Whistle blowing policy

The dependent variables:

1. Asset Misappropriation
2. Money laundering
3. Accounting frauds
4. Frauds committed by senior management
5. Bribery and corruption
6. Regulatory non-compliance
3.4.1 Independent variables

A. Sound Risk Management Framework

With the occurrence of such major financial crisis globally a lot of emphasis is laid on strengthening risk management practices for both financial and non-financial institutions. However, with respect to the financial institutions, it is evident that much attention is being paid to financial risk such as market risk, credit and liquidity, despite the focus being on managing operational risk. Accordingly, major reports have been published by many organizations, such as the Basel Committee, Institute of International Finance and others that highlight the need for effective risk management in financial institutions (OECD report, 2014). In this context, this study intends to verify the effect of risk management on corporate frauds.

B. Data Management and Analysis

An organization’s ability to generate revenue, manage the expenses and extenuate risks is determined by its ability to successfully share, store, retain and retrieve the escalating data. Effective data management practices can bring in large customer base, improve customer relationships which in turn help in generating revenue. According to American Institute of Certified Public Accountant (AICPA) report 2013, accountants play an important role in governing the organization’s data and ensure that it is in accordance with the CG practices of the organization. Since any financial institutions’ operation is based entirely on its customer base, governing the ever-increasing customer data becomes an important part of its CG practices.
C. Strict code of Conduct for BOD

Although people have always questioned the need for having corporate boards, it is empirically proven that their presence matters a lot at the time of organizational crisis. This can be verified as in the case of Enron, Worldcom and Parmalat scandals where the directors in particular were held liable for the fraud. Consequently, more attention is being paid to research on the role of corporate boards. Uzun, Szewczyk and Verma (2004) have demonstrated that the composition of the board and the structure of the supervisory committee were significantly related to occurrence of corporate frauds. In contrast, the study also found that the larger the number of independent outside directors, lesser was the possibility of occurrence of corporate frauds in U.S during the period 1978-200. Nevertheless, not many papers are available on the composition and effectiveness of corporate boards in the financial sector, which motivated this study to investigate the relationship between CG and fraud.

D. Internal and External Control Systems

Internal control system refers to the approved policies and procedures followed by the management in order to carry out smooth and proper functioning of business thereby avoiding various types of risks such as improper maintenance of accounts, unauthorized transactions and frauds which may affect the organization’s financial performance.

On the other hand external control system refers to the government regulations, market competition, media exposure, takeover activities, public release and assessment of financial statements. In spite of the fact that the company’s governance process also comprises of government regulations the role of external control systems in the financial sector is still a mystery.
E. Forensic Accounting

Forensic accounting is a special field related to accountancy profession where the accountants implement their accounting, auditing and investigative skills to detect frauds, bankruptcy and other litigations (Crumbley & Smith, 2005). The role of forensic accountants in investigating corporate frauds has long been identified by many countries and they now play a major role in probing corporate frauds. However the field is still in its nascent stage in India due to rapid increase in “white collar crimes” and the notion that the law enforcement agencies do not have sufficient time or expertise to expose the frauds committed (Lalit Wadhwa & Dr. Virender Pal, 2012). Therefore the researcher anticipates studying the role of forensic auditors and auditing process which may determine the quality of CG practices in the banking sector.

F. Independent auditor’s role

The purpose of designing a set of codes for CG is to enhance the efficiency of auditing process in order to retain the interests of all the stakeholders and investors. This is where the role of independent auditor comes into picture. The auditor has all the authority to capture the offender, eliminate bias from financial reports of the company and report objectively. Recently a lot of emphasis is placed on the role of auditor with respect to CG as auditors’ are solely responsible in detecting the scam. On the contrary, the auditor’s must not be forced into any kind of obligation which may bind his hands from discharging his duties veritably (Prof Hetal Pandya / Vyas, 2013).

G. Role of top management

According to the Basel Committee report on banking supervision published in the year 2014 (Bank for International Settlements, 2014), it is the responsibility of the senior managers to carry out and manage all the activities of the banks in accordance with the
business strategy, risk policies and other strategies as approved by the board. The top management’s personal conduct also contributes significantly in achieving “sound CG” along with the members of the board.

**H. Whistle blowing policy**

Whistle blowing policy in a company refers to the particular internal policy designed for its employees to report to the management about any suspicious behavior or frauds or any kind of infringement in company’s norms or code of conduct. The policy enables an employee to report to the senior managers or top management directly without informing his immediate manager(s). Because of this advantage, whistle blowing policy is considered to be a valuable tool in an organizations effective CG strategy (Cs Sudheendhra Putty, 2012 and Vivek Sadhale & Vikas Agarwal, 2012).

**3.4.2 Dependent Variables**

**A. Asset Misappropriation**

Asset misappropriation refers to the misuse of a company’s assets or resources for an individual’s personal use at the expense of the company. Sometimes it may even involve stealing of the company’s assets for personal interests and producing false records to mask the committed fault (ACFE, 2010 and Rasha Kassem, 2014). Studies have shown that though asset misappropriation might not be visibly significant, disregarding the same may become “an incurable disease” and consequently affect the financial status due to unnecessary expenditure incurred (Orchard, Decker & Kiziran, 2007).
B. Money laundering

Money laundering is gaining illegal money from criminal activities and projecting it to be a source from legal proceedings by concealing its actual source of inflow, ownership and use of funds (Donato Masciandaro, 1999).

C. Accounting frauds

Accounting frauds refer to deliberate falsification introduced in the financial statement to gain unlawful financial advantage by employees, management or any other individuals related to the organization (Kwok 2005). On the other hand, accounting irregularities arise due to inadvertent misrepresentation of facts or omission of certain entries in the financial statements. Both these mistakes lead to economic problems which ultimately find its root cause in fruitless CG mechanism and its inability to detect and prevent such faults (Jaswadi, 2013). For instance the financial irregularities that happened with Enron, WorldCom and Satyam, all point towards a lack of proper CG at some point for the tragedy occurred.

D. Frauds committed by senior management

Also known as “white collar crime”, frauds committed by the members of the top management directly impacts the shareholders, employees and society as a whole. Frauds committed may not always be in terms of capital. It may also include the involvement of top managers in certain activities that are against the rules and regulations of the company or refrain themselves from taking necessary action after being aware of any illegal activity happening in the organization or certain disastrous decisions taken by the managers (Shaker A. Zahra, Richard L. Priem and Abdul A. Rasheed, 2005).
E. Bribery and corruption

Studies have demonstrated that poor CG practices can breed corruption. Corruption pertains to “the misuse of public office for private gains and has both demand and supply sides to it”. CG practices can be affected by bribery and corruption practices of the members involved at various levels including the board members, to managers, employees, shareholders and stakeholders. Good CG is expected to reduce the level of corruption by imposing strict constraints on the officials (Xun Wu, 2005).

F. Regulatory non-compliance

For any organization it is mandatory to comply with the legal framework prescribed by the respective boards apart from the internal rules and regulations of the company. In India the Securities and Exchange Board of India imposes the rules and regulations and frames the guiding principles for companies to protect the interests of the investors. Apart from this, companies are also required to comply with the provisions of Companies Act 1956, Kumaramangalam Birla report on CG, accounting standards issued by ICAI and additional listing agreements with the stock exchange they are listed with (Aparna Sharma, 2012).

G. Practice of Insider trading and Selective leak of sensitive data

Insider trading indicates the practice of buying and selling company’s securities illegally without the knowledge of the public with the intention of making profit or preventing loss in the securities transactions of the company. In India it is considered as illegal trading by SEBI. In this case, the management of the company may take advantage of the confidential and price-sensitive data to make profit for themselves without informing the public investors (Kumar, 2013).
3.5 Model Constructed

Figure 1.1 represents the model developed to investigate the effectiveness of corporate governance on corporate fraud.

The model used in the current study offers a unique impact of CG parameters i.e. risk management, independent auditor’s role, top management role, whistle blowing policy, forensic accounting, internal & external control system, strict code of conduct for BOD and data management & analysis which can be an effective tool in combating corporate frauds in the banking sector in India. This model was tested in the Indian banks (public and private sector) and can be used in other financial institutions and service sector organizations.