

**DOES FINANCIAL REPORTING FRAUD RECOGNIZE BORDERS? EVIDENCE
FROM BANK FRAUD IN IRAN**

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INTRODUCTION

Reliable and high quality financial information is the lifeblood of the capital markets and that quality can be adversely affected by the existence and persistence of financial reporting fraud (hereafter, FRF). The persistence of FRF continues to be of significant concern for the business community and the accounting profession worldwide. Since the passage of the Sarbanes-Oxley Act of July 2002, which was intended to combat financial fraud, the Department of Justice has made 1,300 fraud convictions (Phillip 2008). The 2007-2009 financial crisis caused by subprime loan mortgage shenanigans has also provided incentives and opportunities for management to engage in FRF (Rezaee and Riley 2009). The 2010 COSO report finds 347 cases of FRF during 1998-2007, compared with 294 fraud incidents during 1987-1997 (COSO, 2010). When a company is not effective in generating sustainable performance, management is under more pressure to manage earnings. Furthermore, opportunities to engage in FRF are higher when the company is not doing well financially and is unable to invest in effective corporate governance and internal controls.

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Emerging corporate governance reforms, securities laws and best practices are intended to identify and minimize potential conflicts of interest, incentives, and opportunities to engage in FRF.

Fraud in general and FRF in particular (Enron, WorldCom, Satyam, Madoff, Olympus) are global phenomena. The September 2011 discovery of Iran's biggest bank fraud, totaling 2.6 billion USD, resulted in the arrest of more than 50 suspects, including some government officials (Donya-e-Eqtesad, 2012). This bank fraud involved the use of forged documents to secure credit at one of Iran's top financial institutions to acquire companies including major government-owned companies for the purpose of conducting fraudulent business and transferring money abroad. The primary purposes of this paper are to: (1) discuss reasons for the occurrence of FRF; (2) present fraud in the banking industry; (3) examine bank fraud in Iran; and (4) offer suggestions for preventing and detecting fraud, particularly in the financial services industry.

REASONS FOR OCCURRENCE OF FINANCIAL REPORTING FRAUD

Financial reporting fraud occurs for a wide variety of reasons, including when motives to defraud are combined with opportunity to engage in fraudulent activities. Corporate strategies to meet or exceed analysts' earnings forecasts often pressure management to manipulate earnings. Managers are motivated or, in most cases, rewarded when their bonuses are tied to reported earnings to choose accounting principles that result in the misrepresentation of earnings. Companies are more likely to engage in FRF when the quality and quantity of earnings are deteriorating and management has the incentives and pressures to manipulate earnings.

Economic incentives are common in FRF, even though other types of incentives, such as psychotic, egocentric, or ideological motives may play a role. Pressure on management to meet

analysts' earnings forecasts may force management to manipulate earnings. Management evaluates the opportunity for earnings manipulation and the benefit of earnings management in terms of the positive effect it will have on the company's stock price against the possible cost of consequences of engaging in FRF and the probability of being detected, prosecuted, and sanctioned.

Both 1997 and 2010 COSO reports find senior executives are involved in the majority of FRF cases (83 and 89 percent respectively). The 2010 Committee of Sponsoring Organizations (COSO) report pinpoints the importance of corporate governance research and its relation with the prevention of FRF (COSO, 2010). From Enron and WorldCom in 2001 to Madoff and Satyam in 2009 and Olympus in 2011, FRF has dominated global news over the past decade. There has been ample evidence that FRF has undermined the integrity of financial reports and has contributed to substantial economic losses. Furthermore, fraud has eroded investor confidence in the usefulness and reliability of financial statements. The existence and persistence of FRF in recent years worldwide continues to contribute to financial uncertainty and market volatility, thus preventing global investors from receiving meaningful financial information to make savvy investment decisions.

FRAUD IN BANKING INDUSTRY

Financial reporting fraud (FRF) was a contributing factor to the recent financial crisis and threatens the efficiency, liquidity, and safety of both debt and capital markets (Black, 2010). Furthermore, FRF has significantly increased uncertainty and volatility in financial markets, shaking investor confidence worldwide. FRF also reduces the creditability of financial

information that investors use in investment decisions. For example, Sorkin (2010) reports that the Financial Fraud Enforcement Task Force of the Department of Justice has brought cases against 343 criminal and 189 civil defendants for their fraudulent activities, which have harmed more than 120,000 victims for more than \$8 billion in recent years in the United States.

Corporate governance has evolved as a central issue among regulators and public companies in the wake of recent global financial crises. Companies have recently undergone a series of corporate governance reforms aimed at improving the effectiveness of their governance, internal controls and financial reports. The Dodd-Frank Act of 2010 was passed to prevent further failure of financial services firms, resulting financial crises and to protect consumers and investors from suboptimal strategic and financial decisions and irregularities in major financial institutions. Effective corporate governance promotes accountability, improves the reliability and quality of financial information and prevents financial statement fraud. Poor corporate governance adversely affects the company's potential, performance, financial reports and accountability and can pave the way for business failure and FRF. Corporate governance measures of the oversight function assumed by the board of directors, managerial function delegated to management, internal audit function conducted by internal auditors and external audit function performed by external auditors are vital to the quality of financial information.

IRAN BANKING FRAUD

The biggest banking fraud in Iran history was discovered in September 2011, which involved seven government-owned and private banks and Iranian officials. Several factors including alleged fraudulent loans, fraudulent loan applications and forged documents, collusion and

bribery have contributed to the bank fraud in Iran. These factors are examined in the following sections.

1. Fraudulent loans

Loans are typically offered by banks to meet the financial needs of borrowers and generate revenues for banks. Banks may originate and sell loans for a variety of reasons including generating revenues, increasing liquidity and maximizing their use of capital. Banks in connection with lending activities collect different types of fees. A fraudulent loan, however, is one in which the borrower intentionally defrauds the bank or collude with bank's employees and officers to unjustifiably obtain loans with no intention to pay off. The "borrower" then declares bankruptcy or vanishes and the loan is lost. The fraudulent borrower may even be a non-existent entity and the loan merely an artifice to conceal a theft of a large sum of money from the bank. In the Iran fraud case, Aria Financial Investment and Development Group (defendant) forged documents and bribed banks' officers to obtain loans, which were used to acquire state-owned companies made possible through government privatization initiatives.

2. Fraudulent loan applications

Loan applications are normally submitted to the bank for obtaining loans. These applications should be examined by the bank prior to granting the loan. A letter of credit is often issued by banks for their customers to provide compensation to a third party on behalf of its customers in the event that the customers fail to perform in accordance with the terms specified by an underlying contract. These letters of credit are often available under a credit facility or can be issued for a specified amount with an expiration date.

Customers may engage in fraudulent activities by falsifying information, hiding a credit history filled with financial problems and have unpaid loans to corporations using accounting

fraud to overstate profits in order to make a risky loan appear to be a sound investment for the bank. Aria Financial Investment and Development Group used the loopholes in Iranian regulations on domestic letters of credit to obtain illegitimate letters of credit to transfer about 2.6 billion USD abroad (money laundering).

3. Forged or fraudulent documents

Forged documents are often used to conceal thefts and embezzlements. Banks typically count their money and reconcile their accounts meticulously to ensure every penny is accounted for. Nonetheless, when forged documents are presented to banks and bank employees and officers are bribed not to investigate submitted forged documents; money can be transferred from banks to individuals for personal and self-dealing use. The ineffectiveness of both internal and external bank audits, the inadequacy of internal control systems of the bank, as well as the lack of a vigilant oversight function of the bank's board of directors, particularly the audit committee, provide opportunities for forged documents to go undetected and undiscovered. In the Iranian bank fraud case, a substantial amount of money was borrowed from bank based on forged documents and was used to buy state-owned companies to conduct illegitimate and illegal business activities.

4. Collusion and Bribery

The banking scandal in Iran revolves around a wealthy businessman Mahafarid Amir Khosravi, who allegedly forged domestic letters of credit (DLC) with the help of high-level bank officers (Donya-e-Eqtasad, 2012). Mr. Mahafid Khosravi is accused of using the money, the equivalent of 2.6 billion USD, to start a private bank called Aria Bank. Cabinet ministers and the head of the Central Bank are publicly blaming one another for losing billions of dollars to Khosravi, who allegedly built his steel and railroad business empire through his connections with

the government of Iran. He used the first loan for a quick return project initiated and promoted by government to assist entrepreneurs and established Amir Khosravi Investment holding Company that has about 32 affiliated companies some of which were phony companies. These companies are alleged to have engaged in fraudulent business activities including bribery, corruption and embezzlement.

5. Privatization

In recent years, the government of Iran has started major initiatives to privatize many of state-owned business organizations including many manufacturing firms and banks. This bank fraud and other white-color corruptions and crime recently discovered in Iran suggests that these privatization initiatives have provided incentives and opportunities for friends and relatives of the political elite to gain personal advantages of ineffective and unscrutinized implementation of privatization. For example, the mastermind of this bank fraud, Mr. Amir Mansour Khosravi, is alleged to forge letters of credit from one of the biggest bank in Iran (Bank Saderat) to buy a state-owned steel manufacturing company and to finance dozens of other state-owned companies through his connections with the political elite and government officials (Torbati, 2012).

In summary, some of the reasons for occurrences of banking fraud in Iran are as follow:

1. Fall down of ethics and social values.
2. Lack of adequate and effective corporate governance mechanisms in Iranian banking sector.
3. Lack of supervisory and control by the Central Bank in Iran in establishing appropriate regulatory reforms and enforcing these reforms.
4. Promotion and existence of family oligarchy in banking system in Iran and ignorance of market mechanisms of fair competition and best practices.

5. Inadequate training and ineffective audits by some of the auditing firms that audit banks and their lack of independence and inability to provide early signals of bank fraud.
6. Unsound deregulation in the banking sector in the aftermath of the 2002 privatization initiatives.
7. Lack of training banking employees about anti-money laundry and antifraud policies and procedures.
8. Improper implementation of government programs to promote economic development and investment in so-called quick-return loan investments to advance economic growth in the country.
9. Misallocation of government resources to combat fraud and diversion of resources from investigating bank fraud to fighting terrorism instead.
10. Insufficient resources for bank internal audits and ineffectiveness of many bank internal audits in assessing risks of incentives and opportunities for committing fraud.

LESSON LEARNED FINGERS BURNED

The Iranian Economist (Donya-e-Egtesad) newspaper in its February 21, 2012 issue reports that the session of court charges for the so-called 2.6 billion USD bank fraud was held in Tehran to investigate allegations of the bank fraud, bribery, corruption and conflicts of interest. This fraud case is considered as organized, colluded and well-planned and intended criminal actions by the Aria Investment Group to undermine the economic security of society. The charges brought against at least 39 defendants are fraudulent criminal activities including forging documents to obtain large loans from several banks to conduct fraudulent business, illegally and

influentially buying several state-owned companies through privatization initiatives and using domestic letters of credit to transfer large amounts of money abroad (money laundering). These charges constitute so-called “Mfsdfyarz” or “Corruption on Earth” the highest criminal activity punishable under the Islamic Law.

The indictment was 12,000 pages in 33 volumes against Aria Amir Mansour Financial and Investment Development Group and its several senior executives and also brought charges against another 39 defendants named in the indictment. Allegations are corruption, disruption of the country’s economic system through collusion, corrupting the banking network, financial fraud, obstructing government officials, forgery, falsifying and fabricating documents and conspiracy to commit money laundering. This case is part of the government initiatives to crackdown on white-collar crime, fraud and bribery in Iran and is expected to last for many years. In pursuing its fraudulent business operations, Mr. Amir Mansour Khasravi bribed officials and officers at financial institutions in Iran including banks, insurance and state-owned companies and the former CEO of the largest bank in Iran (Melli) who fled to Canada after the discovery of fraud in September 2011. The entire operation was based on corruption practices of influencing government officials for the achievement of business goals through bribery.

The Iran bank fraud trial started in February 2012 and after about five months of intensive judicial deliberations it was finalized at the end of July 2012. Reuters, in July 2012, reported that an Iranian court has sentenced four individuals to death by execution, two of the 39 defendants are sentenced to life in prison and others received jail sentences of up to 25 years, ordered to pay fines and banned from government jobs (Torbati, 2012). Mr. Mahmoud Reza Khavari, the former head of the Bank Melli, the biggest state-owned bank in Iran, has been alleged to be involved in this bank fraud and has fled to Canada (Torbati, 2012).

Finally, the Supreme Court of Iran on February, 18, 2013 confirmed the lower court decisions and sentenced four convicted individuals to be hanged (Bozorgmehr, 2013). These individuals were convicted under two Iranian Laws of “Aggravation of Punishment of Bribery, Embezzlement and Fraud (the Bribery Law) and “Punishment of Saboteurs in the Economic System”.

The lesson learned from this fraud case is that fraud has many bad consequences for predators who can lose their life and victims who suffer financial losses. Antifraud policies, procedures and practices should be put in place to prevent, detect and correct fraud. Fraud predators such as Mr. Khasravi, do not need any incentives/pressures or rationalization to commit white-collar crimes. All these predators need to have is the capability and opportunity to commit fraud. This capability and opportunity can be monitored, scrutinized and minimized in the following ways:

- Establishment and enforcement of anti-corrupt and bribery laws, regulations and policies.
- Effective implementation of antifraud policies, procedures and practices including anti-money laundering.
- Monitor continuously high-risk bank customers and their activities.
- Approve only legitimate members or customers applicants while avoiding fraudulent ones.
- Pay attention to early fraud signals and red flags.
- Use basic analytical tools such as common sized analysis and ratios to identify abnormalities that need to be further investigated.

- Measure the substance over form in financial reports.
- Investigate fraudulent loans and loan applications including the letter of credit (LC).
- Rededication to ethical values and moral principles and practices.
- Redefinition of corporate goals of profit maximization to the focus on sustainable profit, people and planet.
- Strengthen responsibility and tone at the top including improved accountability for all corporate gatekeepers.
- Restrict compliance with all applicable laws, rules, regulations, standards, and best practices.
- Disclosure of more reliable, transparent, high-quality, timely corporate reports.
- Utilization of credible and objective external and internal audit functions.
- Promotion of whistleblower policies and procedures.
- Use of risk assessment and risk management for all major business transactions.
- Effective and efficient internal controls to prevent detect and correct errors, irregularities, fraud and non-compliance with applicable laws, rules, regulations, standards and best practices.
- Promotion of integrated internal control and financial reporting including risk management.

- Implementation of more effective corporate governance measures in all banks including vigilant audit committee and adequate internal audit.

CONCLUSIONS

Financial reporting fraud does not recognize borders and can occur in any country and organization. Entities of all sizes are susceptible to both employee (theft, embezzlement) and management fraud. The efficiency, liquidity, and safety of the financial markets, both debt and capital markets, have been threatened by the existence and persistence of FRF, which has been a contributing factor to the recent financial crisis and resulting global economic meltdown. The recent bank fraud in Iran was committed by a group of fraud predators in collusion with government officials and bank managers to transfer a huge amount of money abroad and is considered as a threat that undermines the economic security of Iran. Thus, it constitutes “Corruption on Earth” which is subject to the death penalty under the Islamic Law as four of the alleged Iran bank fraud perpetrators are sentenced to death. These threats have significantly increased the uncertainty and volatility in the markets, which adversely affected investor confidence in the banking system and financial markets.

Effective internal and external corporate governance mechanisms, including cost-effective and efficient regulations and proper and uniform enforcement of regulations, vigilant oversight by the board of directors, employment of ethical and competent management, adequate internal controls and risk assessment and high-quality internal and external audits, play important roles in preventing, detecting and correcting financial statement fraud. Corporate culture should create an environment that sets an appropriate tone at the top, promoting ethical behavior, requiring accountability and transparency, reinforcing antifraud conduct, and

demanding “doing the right thing always.” The control structure should eliminate incentives, opportunities and capability for individuals to engage in fraudulent activities. Furthermore, anti-bribery and corruption laws and regulations should be established and enforced to prevent and detect bribery and money laundering. This paper provides insights into the biggest banking fraud in Iran and lessons that should be learned to prevent its further occurrences.

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