Chapter 20
Financial Fraud:
Embezzlement, Ponzi Schemes, and Credit Fraud

ABSTRACT

Fraud is a deception deliberately practiced in order to secure unfair or unlawful gain. Financial crimes affect private individuals, companies, organizations, and even states, and have a negative impact on the entire economic and social system through the considerable loss of money. It is very difficult to estimate the amount of money of fraud around the world since most of the transactions will never be actually reported. Announcing any fraud incident could affect negatively the company that is reporting, since any publicity would make customers lose their confidence in the company and therefore the price of the share would drop significantly. Therefore, companies would not be willing to reveal any assumptions of fraud and would try to keep the whole story away from the media and stakeholders to minimize negative outcomes. This chapter explores financial fraud.

INTRODUCTION

There are many types of fraud that are affecting our day-to-day activities in the financial sector: Insurance Fraud, tax avoidance, offshore investment scams, pyramid schemes, payment card fraud. A Ponzi scheme is an illegal type of pyramid scheme in which money from new investors is used to pay "returns" to previous investors. It creates the illusion that the investment is actually paying off for investors. The scheme would keep going as long as new investors are investing capital; however, this process keeps going on until no more money from new investors is raised and current investors will not get a return. Afterward, the whole scheme would collapse and people behind such financial pyramids would have to face legal challenges. Financial fraud is considered to be one of the controversial topics discussed often in the media. Governments and associations from all around the world are taking serious actions toward minimizing the amount of fraud in companies, and

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to prevent any schemes that would mislead any stakeholder dealing directly with any company i.e. shareholders, consumers, suppliers etc…

BACKGROUND

Fraud is defined in the American Heritage Dictionary, as "a deception deliberately practiced in order to secure unfair or unlawful gain". According to the INTERPOL website, "Financial crimes affect private individuals, companies, organizations, and even states, and have a negative impact on the entire economic and social system through the considerable loss of money." There are many types of fraud that are affecting our day-to-day activities in the financial sector:

1. Insurance fraud;
2. Tax avoidance;
3. Offshore investment scams;
4. Pyramid schemes; and
5. Payment card fraud.

For a person to be involved in financial fraud, the person should be misrepresenting some material facts that could be misleading to others and could lead to actual damage to the second party. Here we can notice that having the intention to mislead third party individuals is very important, since the intention would facilitate the investigation stage. (Adib 2002, Simmons 1995a)

Types of Financial Fraud

Financial statement balance fraud is considered to be one of the types of financial fraud. In this situation, the accountants and auditors would be issuing misleading information in their yearly financial statements that will reflect false assumptions regarding the company. It is very important to notice, that people involved in financial fraud must have the intention to manipulate the market and mislead decision makers, such as creditors, shareholders, and potential shareholders of the company. (Davia et al. 2000: Adib 2002).

Another example of financial fraud, is ordering huge amounts of supplies and materials from wholesalers or manufacturers, and then vanishing with the goods and not paying the bills. (Chmidts 1997) There are many types of financial fraud that we will be discussing throughout our project, our concentration will be financial fraud related to Pyramid schemes. "A Ponzi scheme is an illegal type of pyramid scheme in which money from new investors is used to pay "returns" to previous investors. It creates the illusion that the investment is actually paying off for investors." Here we can say that the scheme would keep going as long as new investors and investing capital; however, this process keeps going on until no more money from new investors is raised and current investors will not in get a return. Afterward, the whole scheme would collapse and people behind such financial pyramids would have to face legal challenges. An example on Ponzi scheme is Bernard Madoff, that was considered to be "the largest investment fraud in Wall Street history". We will be discussing the Madoff case in depth later on during the project, and the mechanism of the Ponzi scheme that Madoff followed.

Impact of Financial Fraud on the Country and Company

It is very difficult to estimate the amount of money of fraud around the world since most of the transactions will not be actually reported. According to Mclemore (1998), it has been estimated that fraud around the world is around 400 billion dollars. It is very important to note that announcing any fraud incident could affect negatively the company that is reporting, since any publicity would make customers lose their confidence in