



# FRAUDULENT MONEY TRANSFERS TO SUPPLIERS AND TOP MANAGERS WITHIN GROUP COMPANIES: A CASE FROM TURKEY<sup>1</sup>

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**Abstract.** Three conditions of fraud arising from fraudulent financial reporting and misappropriations of assets are described in Section 5135.012 of the Canadian Institute of Chartered Accountants Assurance Handbook (*The Auditor's Responsibility to Consider Fraud and Error*). These three conditions are referred to as the fraud triangle. The three corners are as follows: incentives/pressures, opportunities, attitudes/rationalization. Despite new laws and regulations, companies face pressures to meet short-term financial goals, creating a powerful motive for accounting fraud. The author of the present article discusses the case of a group company Volcano: the company belonged to a group which was taken over by the semi-governmental Saving Deposit Insurance Fund as a consequence of the failure of the group's bank to meet its obligations. The case shows how a cash-rich company's resources are drained to outsiders and group managers as a result of its manipulative top management.

**JEL Classification:** M42.

**Keywords:** financial reporting, accounting fraud, Volcano case.

**Reikšminiai žodžiai:** finansinės ataskaitos, apgaulinga apskaita, Volcano atvejis.

## 1. Introduction

Coenen (2008: 2) writes:

People often wonder why so much fraud occurs and why it is not caught sooner, thereby limiting the losses. The answer is simple. Companies have systems in place to help ensure that accounting transactions are recorded accurately and that proper procedures are followed. Companies have policies to guide the behavior of people who would generally strive to act in an ethical manner, but occasionally need rules to dictate their behavior. Those systems, procedures, and policies often work to catch errors and honest mistakes in the accounting process. However, when employee is committing fraud, he or she is deliberately trying to thwart those system and policies. The person is purposely circumventing the system, while at the same time attempting to conceal his or her actions. While, systems, policies, and procedures may be reasonably good at bringing errors to light, they typically can not and do not expose fraud. Fraud constitutes a purposeful disregard for the system and a deliberate attempt to violate that system for personal gain, and most companies' systems aren't designed to stop this.

Three conditions of fraud arising from fraudulent financial reporting and misappropriations of assets are described in Section 5135.012 of the Canadian Institute of Chartered Accountants Assurance Handbook *The Auditor's Responsibility to Consider Fraud and Error*. As shown in Figure 1, these three conditions are referred to as the fraud triangle.

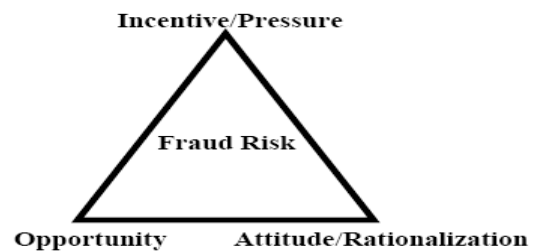


Figure 1. The Fraud Triangle<sup>2</sup>

<sup>2</sup> Incentives/Pressures: managers or other employees have incentives or pressures to commit fraud.

Opportunities: circumstances provide opportunities for managers or other employees to commit fraud.

Attitudes/Rationalization: an attitude, character or a set of ethical values exist that allow managers or other employees to intentionally commit a dishonest act, or they are in an environment that imposes pressure sufficient to cause them to rationalize committing a dishonest act (Alvin et al., 2005: 284).

<sup>1</sup> The article is based on the report presented at the 10th European Academy of Management (EURAM) conference on corporate scandals in the current financial crisis. Tor Vergata University, Rome, 19-22 May 2010.,

## 2. Examples of Fraud from the World

The cost of all frauds is extremely high. For example, when a company manipulates its financial statements, the market value of that company's stock usually drops considerably, sometimes by as much as 500 times the amount of fraud. To further illustrate the cost of financial fraud, Table 1 lists the 10 largest corporate bankruptcies in U.S. history, the amount of each bankruptcy, the month and year each bankruptcy was declared.

Table 1. Largest corporate bankruptcies in U.S. history

Company	Assets (Billions)	When Filed
<b>1. Worldcom</b>	\$101.90	July 2002
<b>2. Enron</b>	\$63.40	December 2001
3. Texaco	\$35.90	April 1987
4. Financial Corp. of America	\$33.90	September 1988
<b>5. Global Crossing</b>	\$25.50	January 2002
<b>6. Adelphia</b>	\$24.40	June 2002
7. United Airlines	\$22.70	December 2002
8. PG&E	\$21.50	June 2002
9. Mcorp.	\$20.20	March 1989
10. Kmart	\$17.00	January 2002

Worldcom, Enron, Global Crossing and Adelphia (in bold in Table 1) were the companies associated with massive financial statement frauds. In addition, six of the top ten bankruptcies in U.S. history occurred in 2002. In total, there was a record 186 companies with combined \$369 billion in debt that filed for bankruptcy in 2002 (Albrecht et al., 2007).

As Timmons and Wassener (2009) write:

The most recent scams in the world occurred in India. Satyam Computer Services, a leading Indian outsourcing company that serves more than a third of the Fortune 500 companies, significantly inflated its earnings and assets for years, the chairman and co-founder said Wednesday, roiling Indian stock markets and throwing the industry into turmoil. The chairman, Ramalinga Raju, resigned after revealing that he had systematically falsified accounts as the company expanded from a handful of employees into a back-office giant with a work force of 53,000 and operations in 66 countries. Mr. Raju said Wednesday that 50.4 billion rupees, or \$1.04 billion, of the 53.6 billion rupees in cash and bank loans the company listed as assets for its second quarter, which ended in September, were nonexistent. Revenue for the quarter was 20 percent lower than the 27 billion rupees reported, and the company's operating margin was a fraction of what it declared, he said Wednesday in a letter to directors that was distributed by the Bombay Stock Exchange.

According to Marshall (2009), the World Bank's annual World Governance Indicators rate U.S. regulatory quality at 90.8 out of 100; India is rated 46.1, below South Korea (78.6), Malaysia (67.0) and Thailand (56.3), but above China (45.6), Indonesia (43.7) and Vietnam (35.9), while assessing

the integrity of accounting practices, the Economist Intelligence Unit gives India a rating of 2 on a scale of 0 to 4, where 0 is the best (that puts it above China, the Philippines and Vietnam, rated 3, and Indonesia, rated 4). As Marshall (2009) states, '[t]he apparent message from these rankings is that a corporate scandal in India was hardly unexpected, but that other emerging Asian economies are even more vulnerable and investors in China and Indonesia have plenty of reasons to be worried'.

Despite new laws and regulations, companies still face enormous pressure to meet short-term financial goals, creating a powerful motive for accounting fraud. Outsized executive compensation grows by the year, offering another rich incentive to cook the books, and there is no certainty that the Congress will continue to fund regulatory budgets at current levels (Johnson and White, 2006).

## 3. Information about the Case

The following case is about one of the reports that I and my colleague prepared while being employed as auditors by the semi-governmental Savings and Deposit Insurance Fund of Turkey (the Fund). All the names mentioned in the description of the case are changed.

The case is about a group of companies (the group) including a bank (the bank). The bank being the largest company of the group had been a liquid entity until March 2001. In March 2001 the bank became illiquid, not able to perform its short-term payments. Illiquidity was caused by mismanagement, malpractices of the bank's management, misappropriation of the bank's money within the group companies, lack of efficient independent audits, lack of government control. Public's deposits were at stake, and there was a risk that these deposits would never be paid back. As a consequence, the Government took over the bank and its group companies. It was not the only bank that was taken over by the Government, another 20 banks and their group companies were taken over at that time. It was the greatest of the crises that the country went through since the proclamation of the Republic of Turkey in 1923.

As Frankel (2009: 2–3) states,

...market regulators should follow a process similar to bank regulation. They should continuously examine financial market intermediaries and even large issuers. Regulators should be most diligent in the "good times", when market prices rise. They should examine the large corporations and institutions and those whose share prices consistently rise rather than fluctuate. Most importantly, regulators should closely examine the institutions and structures that received relief from legal constraints and were allowed to engage in innovative practices. Exemptions from the law must be coupled with close government watchfulness.

We were assigned by the Fund as auditors to uncover the financial scams that might have existed within one particular group. The case that is described refers to an event in one of the group companies. We have uncovered many other accounting malpractices within the group during our audits between January 2003 and August 2005.

The case is the first event within one of the group companies called Volcano that happened during our examination of its financial statements for the years 2000, 2001, 2002 and 2003 (until August 31). Volcano is a data transfer company. It receives data from the Istanbul Stock Exchange and delivers it to its customers through data transfer lines.

The Fund, with reference to the Banking Law, which enables the Fund to take over the rights of a company owner, its management and auditing, excluding the dividend rights, has decided to assign new management and audit teams to the Volcano company on 1 August 2003, two and a half years after the takeover of the bank. The decision was taken in order to accelerate the collection of the Fund's receivables from the group.

#### 4. The Events in Volcano

For this particular report, we have examined 90 cash payment transactions recorded between October 2000 and August 2003. We have discovered that more than TL 1.3 billion (USD 1,484,074) has been drained from the company through irregular-unlawful transactions. These irregular transactions have been classified into:

a) payments made to group companies namely C5, Banet, S&C, Smedia, Universe, Intfashion, Mdelivery, and MMM Advisory Services (MMM);

b) payments made to YHB Law Firm (YHB), Lawyer AHG (AHG), K Accountancy Services (K), and a natural person Mr. SC;

c) payments to those who did not work for Volcano but worked for another group companies. Those payments were either made through Volcano's payroll or under the name of advisory services.

Payments under item (a) cover half of the transactions. The total amount of these payments is USD 960,827. The largest part of this amount is based on two service agreements. The first is the agreement with Banet on 31 August 2000. It covered technical advisory, maintenance and data line leasing services. According to the agreement, Volcano paid USD 28,500 plus the Goods and Services Tax (GST) per month. According to our market research, in comparison with other companies rendering the same services, the payments were eight times higher than the market rate. This agreement was not at arms length with Banet and was a violation of the Corpo-

rate Tax Law Rule 17. According to the Rule 17, 'if a company realizes transactions involving amounts which are apparently higher or lower than the amounts in arms length transactions in the market or at no amounts at all with its shareholders or other companies or real persons whom the company is directly or indirectly in association with. In which case the company's earnings will be considered as covertly distributed'. Here, illegal transfer pricing among the same group companies is referred to. Such not at arm's length transactions between related parties are prohibited. International Accounting Standards Board (IAS 24 Related Party Disclosures) also expects companies to disclose their related party transactions and prohibits any transactions realized in violation of the arm's length principle

A statement that related party transactions were made on terms equivalent to those that prevail in arm's length transactions should be made only if such terms can be substantiated (IAS 24 Related Party Disclosures, paragraph 21).

From the group perspective, the objective is to drain money from a cash rich-company Volcano to a cash-poor company Banet. Transfer pricing has throughout the history been a hot issue in international businesses.

The second service agreement was also made with a group company called S&C-A, a local broadcasting TV company, on 1 September 2000. The agreement covered the lease of VBI-electronic lines on TV screens. Under this agreement, Volcano paid USD 10,000 plus GST per month to the lessor. With reference to our market research, this amount was four times higher than the amount that would have been realized between two independent firms in an arm's length transaction in the free market, and this agreement was also a violation of the Turkish Corporate Tax Law.

Another interesting finding was that, despite the fact that Volcano made service agreements with group companies and invoices received thereof, payments were being made to different companies within the group. If a group company had a receivable from Volcano based on an invoice, the payment was expected to be made by Volcano to this group company. Besides, there was no written agreement regarding the transfer of a receivable between the service supplier company and the other group company to whom the payments were made. These payments violated the Law of Obligations Rule 163 which provides that a transfer of a receivable is not valid unless otherwise written.

The previous management team of the Volcano was acting on the basis of the manipulations organized by the top managers of the group, namely, the holding company's (holding) managers. The top managers of the holding would make the decision as

to how to finance the companies within the group. As previously said, they would transfer cash from cash-rich companies like Volcano to cash-poor ones like Banet. Various mechanisms were developed to transfer the cash, and the transfer of money through service agreements was one of those mechanisms. Sometimes cash needs were so urgent that the top managers were not even in position to design a service agreement between the rich and the poor and ordered the payment to be made to another unrelated group company. Two examples of such payments which were to be made to S&C (a group company) are USD 290,723 made on 27 October 2000 and USD 101,619 made on 11 November 2000. Both payments were made to C5 (a group company) instead of S&C without a written consent of S&C.

Payments under item (b) cover the payments to YHB, AHG, K and Mr. SC (third party advisors) totalling to USD 154,381. Those payments were made under the name of 'advisory services'. At the time of the payments, Volcano's legal independent auditor was Company D (which rendered audit and tax advisory services) and the legal representative was lawyer Ms. DS. Both parties rendered their services based on written agreements. None of the recipients except K of USD 154,381 had a service agreement with Volcano. We have seen neither any board of directors' (BOD) resolution regarding the purchase of services from them, nor any report provided by these companies as against the money that was paid to them. We have further solidified this information after having the accounting manager's verbal explanation in this regard. An example of such payments is the payments of USD 16,109, USD 27,170 and USD 23,705 made to YHB on 20 May 2001, 11 June 2001 and 20 July 2001 respectively. The explanations on the invoices said: 'legal services for capital increase and share sales and purchases'. These services are ordinary services that could have been realized by the company's legal representative; besides, the sum paid was above the market rate for such services.

Payments under item (c) cover the payments made to people employed by other group companies who did not work for Volcano. Their employment was due to Volcano's being a cash-rich company; by doing so Volcano was able to deduct those expenses from its taxable income which was a tax evasion. The total of such payments was USD 366,866. The Fund expropriated group companies in a gradual way as it considered to be necessary in the then circumstances. The interesting finding was that these people's payrolls have been transferred from their original companies to Volcano after the Fund took over the bank on 15 March 2001. After this date, the source of money for the group was under the control of the Government. The bank was illiquid as well as

the majority of the group companies. Volcano still had cash and was not yet taken over by the Fund, so it was the last resort to milk cash to the other group companies. For example, one person was transferred to Volcano's payroll on 24 March 2001 and worked until the retirement on 30 May 2001. Another example is Mr. SC who was a top manager in the group. His payroll was transferred to Volcano in March 2001, and he was paid salaries on Volcano's payroll until 31 October 2002. Later on he was paid by the means of expense vouchers for seven months until 1 May 2003, the total of the seven months' payments being USD 35,213. The explanation on the expense vouchers said that the payments were made for 'advisory services'. The total of the payments for Mr. SC and for Ms. NAM (another upper level manager in the group) until 1 August 2003 was USD 208,982. Ms. NAM and Mr. SC were, in fact, salaried managers. A salary, according to the Income Tax Law Rule 61 is defined as 'the total benefits either in the form of money or goods provided by the employer to the employee for the services of the latter'. A similar definition of a salary is provided in the Labour Law (Law No. 4857). The legislator did not make any distinction between the services provided by an employee (for example, advisory services or physical work). With reference to these definitions, payments under the name of 'advisory services' had to be regarded as salaries and be subject to income tax; and 'converting' high salaried managers into 'advisors' is a way of tax evasion. The company's management team chose the expense vouchers method of payment to avoid higher income tax brackets on a progressive taxation on incomes. By doing so, the managers evaded additional income taxes for the employees who were receiving higher salaries than the others. On the expense vouchers, the tax rate was fixed regardless of the amount paid, whereas the Income Tax Law requires higher tax rates on higher salary levels. As auditors, we need to prove our fraud theory and, accordingly, we need to establish the intent of the managers.

Hylton (2009: 13) writes:

In defining the terms primary volitional and secondary volitional, I implicitly assume that courts have no way of determining the thoughts inside someone's head. In every case, the level of intent is inferred from the facts. If the facts are such that the average person would not have acted in the way the defendant did, knowing what the defendant must have known, unless he intended to harm the victim or at least was content with harming the victim as a step toward some other goal, then a court will infer intent to harm.

According to the Turkish Income Tax Law (Law No. 193) Rule 9, expense vouchers are prepared for the purchases made from peddlers who do not own a shop or a place to work. Those peddlers or small sized farmers pay either no tax or a lump sum amount to the Government; the tax office name and

the tax number are indicated on the voucher. Normally, these revenues and expenditures are for small amounts not meant to be continuous activities like advisory services for thousands of dollars. On the vouchers for payments to those persons, neither the tax office name nor the tax number were indicated. Apart from the two abovementioned managers, there were 6 other managers and top managers on Volcano's payroll. These examples make it clear that the managers had the intent to evade the tax burden.

### Conclusion

As a principle, the company itself as a legal entity is responsible for the actions of the BOD. However there are exceptions to this rule. According to the Turkish Commercial Law Rule 339, '[a] BOD member will be personally liable for the losses incurred by third parties based on his/her falsified explanations in any way whatsoever about the company's current situation'. In addition, the Law of Obligations Rule 528 requires 'BOD members to work and care on company's affairs. If any BOD member based on his/her fault causes losses to other BOD members, he/she will be personally liable for such losses without any claim of settlement by prior gains caused by the same member'. What regards legal auditors appointed according to the Turkish Commercial Law (auditors on a company's payroll), they are required to examine the legal books of the company at least twice a year in search of any malpractices. They are also to report their findings to the BOD. If the BOD does not take the necessary actions, they can convene the shareholders to take a decision about the BOD. With reference to the audit findings mentioned above, the former members of the BOD and the legal auditors of Volcano (who were appointed according to the Commercial Law) were liable for the financial losses (USD 1,484,474) in this particular event (examination of 90 payment transactions). They were liable as the company incurred losses due to their decisions and government—the Fund was not able to collect taxes. Auditors who were to control the actions of the BOD were also liable for the lack of control. In fact, it was a scam organized by the BOD and auditors acting in harmony, because these people were in close relationship with the group's owner—one single person. They were appointed by the owner. It was the owner and his well-paid close associates, friends, lawyers (like YHB) who were making decisions for the whole group. They acted like a scam team which organized all wrongdoings in the companies. Due to the lack of external and internal control, they discovered that there was an opportunity to use the public's money. The group consisted of about 60 companies, and these people literally were managing the whole

group. Salaried managers or top managers were acting according to the decisions taken by the scam team. They acted in harmony with the scam team (rationalization of the behaviour) and could not get out of the circle, because either they had good salaries (incentives) or could not find employment elsewhere (pressures) or never thought that the Government would intervene and try to squeeze the companies to get as much cash as possible to pay the public's money (opportunity).

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## APGAULINGI PINIGŲ PERVEDIMAI TIEKĖJAMS IR VADYBININKAMS BENDROVIŲ GRUPĖSE: TURKIJOS ATVEJIS

Cenap ILTER

**Santrauka.** Kaip rašoma Kanados patvirtintų apskaitininkų draudimo žinyne, yra trys apgaulingos turto finansinės apskaitos ir jo neteisėto nusavinimo prielaidos: iniciatyvos ir spaudimas, galimybės bei racionalizavimo nuostatos. Nepaisant naujų įstatymų bei reglamentų, bendrovės susiduria su dideliu spaudimu siekti trumpalaikių finansinių tikslų, o tai pastūmėja vesti apgaulingą buhalterinę apskaitą. Perviršinis vadovų atlygio padidėjimas – taip pat viena iš apgaulingos apskaitos priežasčių. Tyrimas atliktas remiantis Volcano bendrovės finansinėmis ataskaitomis. Bendrovė buvo likviduota dėl grupės banko nesugebėjimo padengti skolų ir grupės vadybininkų manipuliacijų.

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