The Implications of Economic Fraud – Legislative Analysis, Social Impact and Generic Risk Detection Models

Mădălin-Mihai Moțoc
Bogdan-Dumitru Cosofret
„Alexandru Ioan Cuza" University of Iași,
Doctoral School of Economics and Business Administration Romania
madalin.mm995@gmail.com

Abstract

The purpose of this paper is to investigate the impact that economic fraud is playing in economy, along with a legislative analysis to see if the evolution of legislation keeps track with the methods of fraud. This paper presents the main models for detecting the risk of bankruptcy.

This paper presents a theoretical approach to the concept of fraud, explaining how legislation can prevent economic frauds, completed by presenting the social impact that fraud has in the society.

The incursion into the field of fraud brought to attention it's impact in the social and economic life, legislative evolution being the main key to prevent future frauds.

The detection and prevention of fraud began with the understanding of a fraud. Knowing why a fraud appears represents the first key in diminishing as much as possible the fraudulent actions, regarding business environment.

Key words: fraud, legislative evolution, bankruptcy model
J.E.L. classification: G33, H26, K35, K42

1. Introduction

Economic fraud and money laundering are a growing issue with the global economic crisis of 2008 – 2012, brought on by the public, local organisations, world governments, economic and monetary unions.

The current state of knowledge in the fraud field and and implicitly the database constituted as a support consists mainly of books and manuals with thematic reference focused on the study of fraud in reorganization operations, specialized scientific articles, reports of international bodies on combat tax evasion, economic fraud and legislative texts especially from the Romanian space to observe the evolution, the coverage area, the treated and documented cases and the significant changes appeared from the legislative changes to another.

Consequently, in order to develop a documented scientific study, the evolution of the legislative framework of the research topic is initially considered, for the region (space, zone or area) to which this research is addressed.

For this study I choose to debate the evolution of legislative terms related to fraud in the field of reorganization and insolvency procedures among with the impact that economic fraud has in a consumer society.

2. Theorethical background

In most cases, fraud is carried out of a desire to evade the payment of certain obligations, to conceal certain financial benefits or to protect the interests of the perpetrator. According to KPMG Romania, 63% of reorganization operations (including division, merger, insolvency and bankruptcy) are liable to be an economic fraud, still presenting an area of interest in the the study and deepening of fraud (or illicit tax evasion).

The capitalist business model presents a relatively new methodology, taking into account a post-communist economy, where the term „business" was not understood at the same level as now. The legislation of „business machines" has been largely transposed from the European law, also before and after Romania's accesion to European Union, due to the need to align with legislative standards and more.

The research topic and the direction followed by choosing the topic and structuring the objectives to be followed required a thorough analysis of the literature in the field of economic fraud, especially in the field of reorganization operations fraud.

The specialized literature in the field of economic fraud has numerous research materials and the importance of research in the field of fraud lies in their ability to solve the current problems of a globalised economy. Depending on the specific research chosen for study, the literature which we took in consideration in present paper presents, breaks down, explains and proposes recomandations in estompation and why not eradication of the evasionist and illicit fraud phenomena.

In order to understand the acctual level of fight against economic fraud, it is important to have a brief view of the legislative framework regarding „the war of XXI century" – fraud.

In Romania, the legislative framework regarding the treatment of the reorganization procedures of the economic entities was born after Romania's exit from the communist block.

The legislative history of the reorganization procedures begins in 1995 with the adoption of Law no. 64/1995 *on the procedure of judicial reorganization and bankruptcy*, valid until 2006. The basis for the adoption of this law was the coverage of the debtor's lialibities through the reorganization procedure or through that of bankruptcy.

The doctrine defined the dual nature of the procedure, to be at the same time a remedy and an instrument of enforcement on the property of the debtor who is unable to pay.

Law no. 99/1999 on some measures to accelerate economic reform came as a supplement to Law no. 64/1995, the most important aspect being the replacement of the phrase "judicial liquidation" in bankruptcy, the purpose of the law being reformulated to this extend. The most important changes refer to a payment of the liabilities of the debtor who is temporarily unable to pay either by reorganizing the main activity and implicitly of the enterprise, or by declaring bankruptcy. Law no. 85/2006 on the insolvency procedure repealed Law no. 64/1995, being valid with subsequent amendments and completions until 2014. The basis for the adoption of this regulation was the legislative alignment of Romania with the mandatory rules of the European Union, on the occasion of accession in 2007. The purpose declared and treated by this rule was to start a collective procedure to cover the balance sheet liability of the insolvent debtor. Law no. 86/2006 is considered in the literature (Pătrașcu, 2016, p. 46) as the main legislative evolution in terms of reorganization, insolvency and bankruptcy. A significant change is found in the status of the syndic court, the insolvency practitioner and the creditors. From this moment, the syndic judge is in charge of only jurisdictional attributions, the decisions of administrative and opportunity nature being taken by the insolvency practitioner and implicitly by the creditors.

In 2009, Law no. 381 on the introduction of the preventive concordat and the ad-hoc mandate, repealed on October 25, 2013 until October 31, 2013 by Government Emergency Ordinance No. 91/2013. The purpose of this rule was to save the economic entities in temporary payment difficulties, in order to continue the proposed object of activity, to keep the number of jobs and to cover the debtor's debts through amicable debt renegotiation procedures or by concluding a preventive agreement.

In 2014, the current legislative framework on insolvency prevention procedures and insolvency by Law no. 85/2014 being regulated to a large extent all the provisions on insolvency and bankruptcy.

Law no. 85/2014 is nicknamed the Insolvency Code, making a number of amendments to participants in the insolvency proceedings in order to eliminate some of the difficulties in the old regulations (especially as regards the judiciary, part of the insolvency process). The need to impose such legislative rules arose due to the need to ensure a balance of positions held by the actors involved in the insolvency proceedings on the one hand, but also to streamline procedural mechanisms on the other, thus achieving an alignment with current European standards. The law is practically a transposition of the active legislative text at European level, adapted to the economic market on the Romanian territory.

Regarding the division and merger, the main legislative norm currently in force is Law no. 31/1990 with subsequent amendments and completions, which treat in a similar manner both the merger and the division procedure, these being in fact changes in the status of a legal entity in the mirror. The main consideration from which the drafting of legislative texts on reorganization operations is based is that fraud, in most cases (according to the National Institute of Statistics) is committed at the time of declaring insolvency and less in other operations of insolvency. reorganization, this being the starting point in the scientific research relevant to this field. For the same reason, we consider that the most representative moment in which economic fraud can take place is when the state of insolvency is declared publicly, which is why it will continue to be the main axis of scientific debate, without excluding the others. , as evidenced by the number of scientific publications dealing with economic fraud in insolvency and less in division, merger or dissolution.

At the level of the European Union, the issue of economic fraud is closely monitored and debated by all decision-making bodies. In fact, the global economic crisis has called into question the establishment of a European tax monitoring body, namely EuroFisc, with the stated aim of combating economic fraud through illegal tax exemptions, double taxation, tax havens and others.

The European tax monitoring body (Eurofisc) aims to establish a unanimously accepted legislative framework adopted and adopted by the Member States of the European Union on tax evasion, money laundering and economic fraud, being divided into separate chambers for the adoption on the one hand and the application of the new legislation on the other. However, being at the draft stage, it is necessary to move to ways to prevent the risk of fraud currently under debate and ongoing.

3. Research methodology

The documentation considered in the elaboration of this study was made through a research of the specialized articles in the field of economic fraud, considering aspects such as *insolvency fraud*, *bankruptcy risk models*, *legislative evolution* in the field of economic fraud, together with an detailed analysis of the legislative evolution of the aspects related to fraud in the economic field. The basis of the research study in the documentation of the present paper consists of 273 specialized articles from economic, financial, legal and civil and criminal law journals, together with the analysis of all significant legislative aspects of post-december Romania evolution of law.

There is discussed nowadays the need to implement a model for detecting the risk of bankruptcy and fraud for small and medium-sized entities (SMEs) and brings to the fore an updated calculation formula for Altman economists. and Sabato which is liable to bring added value especially to the banking sector, as a key player in the lending process and economic partnership with economic entities (Tobback, 2017, p. 76).

The fear of failure in business, the desire for rapid over-enrichment of entrepreneurs, the mentality that invokes a series of taxes and taxes unduly paid (in the opinion of entrepreneurs in both developed and developing countries) are reasons invoked that have raised a number of questions at the level of economic regulators. Thus, the need to update the Classification of Occupations was imposed, thus appearing a new position, that of expert in economic fraud, a position derived from the statutory financial audit.

Corruption, irregularities and fraud are caused by a number of imperfections in the official legislation regulating both public and private sector activities. Unofficial norms are treated in the same way, among which we mention personal value systems, ethics and morality in business, as factors of occurrence of economic fraud in the context of the opportunity for fraud. The root causes are mainly:

1. Dysfunctions of the economic market;
2. Inadequate and outdated legislation;
3. The exercise of coercive power to a too small or too great extent by public administrations;
4. Lack of monitoring and control by the competent authorities;
5. Low educational standard, culture, morals, ethics and value system of economic actors below the minimum limits.

The stated purpose of EuroFisc is to limit the occurrence of breaches in the tax system and the elimination of clichés that make possible accounting and tax fraud, measures that provide (Huckfeldt, 2015, p. 60):

- An assessment of prevention techniques and the effectiveness of existing measures;
- Correction, repeal or adaptation of measures already in place in the Community bloc;
- An assessment of the awareness of economic actors on the effects of their actions (with the role of enhancing the value system);
- Manage anti-fraud measures in a practical, structured and targeted way.

A generally valid definition of tax evasion has been established in OECD reporting on the taxation of organizations, while distinguishing between two forms of evasion: acceptable (or tolerable) evasion and unacceptable (intolerant) evasion.

In the end, it all comes down to recognizing acceptable and unacceptable practices, the impetus transmitted by the business environment being usually the opposite of what the legislator wants.

The issue raised by economic fraud in general and insolvency fraud in particular is one that concerns all states of the world, more or less civilized. We have previously raised concerns about this issue, which seems to almost always break down legislative barriers, causing considerable losses in each financial year.

Economic models for bankruptcy risk have been a desire of the global economic market to standardize financial information long before the advent of international financial reporting standards. The usefulness of such a system is undeniable, being a measure of alignment of entities and overall understanding, from a single formula, of the activity of an entire business (Yusof, 2014, p. 426).

However, the issue of fairness and viability of implementing such a model arises. It takes into account the size criteria, the value of sales, the type of activity (production, services), the correctness of the data entered in the annual financial statements and the correctness of the primary accounting established by the entity (Power, 2013, p. 533).

The first large-scale model, considered successful in the analysis of bankruptcy risk in both financial practice and literature is attributed to EI Altman, published in its primary form in 1968, bearing the function name Z-score. Although it was considered a simple model at first sight, this model had an analogous effect on anticipating the risk of bankruptcy of an economic entity, being considered the same that the Black-Scholes model had on the evaluation of derivative financial mechanisms.

The model designed by Altman makes a prediction based on a discriminant analysis, being used to develop models for predicting and classifying the membership of some examinations to certain balance categories considered a priori. In the case of this model, the observation set is characterized by a number of economic entities classified as solvent and insolvent. It is considered a classification model with an accuracy of around 70%.

Similar to the Altman model, the Conan-Holder model (named after the economists who created it) was launched in 1979, a model that samples a number of 190 SMEs, also using a 5-variable formula, similar to the Altman model being quite large. The companies under analysis are in the field of manufacturing, construction companies, wholesale entities and transport companies.

The Taffler model did not enjoy as much notoriety as the Altman and Conan-Holder models, being based on the analysis of four balance sheet criteria, considered to be the most important (profit, current assets, short-term debt and total assets).

The Beaver model belongs to the English economist of the same name who can be said to have started the analysis of the risk of bankruptcy. The model is an unstylized form of the Altman model, the model of economist E.I. Altman being a processing of the Beaver model. The model is based on the analysis of 5 factors, namely the return on assets, current liquidity, the coverage ratio of the value of assets in working capital, the Beaver ratio and financial leverage.

In the second half of the 20th century, an attempt was made to stylize a model for detecting the risk of bankruptcy that was passable, accurate and provided relevant information on entities in all sectors of activity. Thus, in addition to the models mentioned above, there are also the models Eisenbeis (developed in 1977), Ohlson (1980), Jones (1987) and others less popular.

The work we want to do aims to build a model for detecting the risk of bankruptcy that can cope with a constantly changing economic market, increasingly volatile and exposed to the risk of bankruptcy through fraud and tax evasion, using the models, the concepts and theories used mainly by the researchers stated above.

In 2020, the topicality of the formulas, calculations and samples used is discussed. Basically, are these models more likely to detect the risk of bankruptcy with satisfactory accuracy? The current economic market "claims" that it does not.

4. Findings

Instinctively, public opinion tends to be the one in which economic fraud does not exist and cannot exist given the technological advance, globalization, opening of borders, the vigilance of the legislator who gives the impression of keeping pace with technology and increasingly diversified business methods. On the contrary, say experts in economics, economic fraud is now more prosperous, harder to detect, easier to do and more tempting (Livne, 2008, p. 21).

Elements related to fraud have been invoked and have been the basis for radical decisions, such as Brexit, the bankruptcy of Lehman Brothers, Citibank, Merrill Lynch and many other giants (Eisenberg, 2017, p. 53).

The social impact that the unfavorable effects of economic fraud (in the broadest sense of tax evasion in all its forms) have is a lack of personal and private investment, a limitation of economic confidence, a convulsive fear of the banking sector and related lines and limited action. stock exchange trading among the public (Pontell, 2005, p. 315).

Illicit financial flows are the total capital outflows of the private sector that come from and are used illegally. The loss related to economic fraud in the reorganization actions of private actors in 2017 amounted to 630 billion dollars, about 4.3% of the GDP of developing countries (excerpt from the OECD Report of July 2019). Data on economic fraud are almost always informative, as there is no real source of data on which databases can be processed, which are often extrapolations of detected cases. Judicial reorganization operations, including liquidation, insolvency and bankruptcy operations, raise serious questions at EU level about the fairness of economic acts provided by operators seeking insolvency against creditors 1, 2 or 3 years after the start of business. thus there is less of a problem of mismanagement and more of obscure interests towards financial and commercial creditors who have invested in good faith in the business of the third party. In this way, such an action generates a chain of dominoes, especially towards SME creditors and those who have invested considerable amounts in the assets of another economic actor requesting insolvency at a certain moment (Halbouni, 2016, p. 602). Insolvency actions cannot be banned, legal terminology is deeply rooted in today's economy (Mazumber, 2010, p. 130), considering (and being treated) as part of a person's life process (birth, resource consumption, benefit generation, end of life). The European Union, together with all regulators and reviewers, is aware of these issues and calls for morale, ethics, economic equity, respect for economic partners and reservations about the "boost" of business that many entrepreneurs have, investing in business. their most often borrowed amounts.

Addressing these considerations, tax regulators have identified a number of relevant ways to achieve economic fraud, especially in developing countries (including Romania). These include:

1. Incorrect financial reports, non-declaration of personal incomes or registered profits in order to evade the direct taxation of the elements of the nature of incomes or of the resulting profits;
2. Poor valuation of the value of trade in intrastat transactions, being a very widespread variant of capital transfer to states with a more precarious tax system, with many gaps or tax havens;
3. VAT fraud, representing the issuance of false declarations vis-à-vis value-added tax transactions;
4. Bribery, corruption, conflicts of interest and abuse of power by public bodies.

Competent bodies at all hierarchical levels (local, national, European, international) are looking for viable solutions to stop or limit as much as possible the effects of willful economic fraud. Thus, it is tried to bring under the umbrella of state bodies the newly established economic entities through financial support programs (to avoid external borrowing to support the activity) imposing strict

controls and firm steps in the beginning of economic activity. On this premise, programs such as SME Invest, Start Up Nation with adjacent programs, state-guaranteed loans and investment grants, started as pilot programs and have now become more widespread.

5. Conclusions

The concept of economic fraud is an economic and social phenomenon of major importance in the current process of increased globalization in which we take part, research and legislative treatment of this phenomenon concluding one thing, namely that the phenomenon may be the much limited, eradication in this area being practically impossible. Economic fraud in the reorganization of economic entities still requires analysis and research in order to arrive at a complete and correct perception of its size, the adverse effects it attracts on its own and the overall and detailed knowledge of the elements that make possible the occurrence of such a phenomenon.

The punctual treatment of the operational objectives of a field of knowledge has the role of formulating the main objective of the paper. We consider that by enunciating and analyzing all the constituent elements of an action proven to be economic fraud, a "recipe" of such an action can be made because, once the criminal mechanism is understood, the illicit element can be at least limited.

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