A REVIEW STUDY ON CORPORATE FRAUD'S NEGATIVE EFFECTS ON CORPORATIONS

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Abstract: The economic repercussions of corporate fraud are significant and widespread. The seemingly unstoppable misbehaviour of corporate managers harms shareholders, stakeholders, and the financial system. Corporate fraud is defined as illegal, unethical, and deceptive actions committed by a company or an individual acting in their capacity as an employee of the company. It harms the company's reputation and is capable of causing direct financial loss. It could make it harder to attract and retain business partners, customers, and employees. It could lead to a breach of banking covenants or expose the company to regulatory costs, legal fines, and sanctions, which could jeopardise its ability to maintain a competitive advantage. The purpose of this article is to explore the negative effects of corporate fraud by using basic literature review methods to search, critically appraise, and synthesise the studied issue. It summarises the evidence on the researched topic by synthesising the findings of multiple primary studies on the negative impact of corporate fraud. In developing the discussion themes, a case study on the previous fraud scandal was analysed to explore corporate fraud’s most common and threatening implications. Regarding the effects of fraud, this topic is important for the management of financial institutions, accountants, auditors, and everyone else involved.

Keywords: Corporate Fraud, Corporate Governance, Corporate Misbehaviour, Fraud Implications, Review Study

1. Introduction

A corporation is composed of numerous stakeholders, including customers, employees, investors, vendor partners, the government, and society. In all dealings, a corporation should be fair and transparent with its stakeholders (Ramakrishnan, 2008). Globalisation has opened a borderless door of resources for corporations, and global market competitiveness is unavoidable. Thus, it is crucial for the corporation's long-term growth and success to adopt and display ethical behaviour. Individual and corporate greed has increased dramatically over the past few decades, to the point where it now permeates every aspect of our lives and society. Corporate fraud and misconduct continue to pose a threat to the economy from a macro and micro perspective (Gupta & Gupta, 2015).

Fraud is a type of criminal activity defined as an abuse of position, false representation, or prejudicing another's rights for personal gain (CIMA, 2009). Ruin (2009) defines fraud as an act committed by a party or individual in order to obtain benefits, avoid obligations, or cause financial or non-financial loss to another party. Individuals or groups of people commit fraud when they gain an unfair advantage in an organisation. Internal or external individuals in an organisation can commit fraud by preparing a false financial statement in order to entice people to invest in the entity (Xu, Zhang, & Chen, 2018). Corporate fraud is defined as an action performed by people in an organisation that is done in a dishonest and illegal manner that gives an advantage to the perpetrating individual or organisation. White-collar

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employees are responsible for the majority of corporate fraud. Fraud is a significant issue for modern businesses. Every two years, the Association of Certified Fraud Examiners (ACFE) publishes a report on Occupational Fraud and Abuse. In 2022, the ACFE analysed 2110 cases of fraud. According to the report, losses exceeded $3.6 billion, averaging $1,783 million. The most expensive are financial statement frauds, which result in an average loss of USD 593 million. Moreover, a typical organization's losses were caused by employees. The most prevalent was asset misappropriation when an employee steals or misuses an employer's resources, with a median loss of $100,000 per incident. Corporate fraud occurs everywhere in the world. In the ACFE report mentioned previously, fraud occurred in nearly 133 countries, illustrating the scope of these illegal practices, with the highest incidence in the United States and Canada (675 cases or 36 percent) and the lowest incidence in Eastern Europe and Western/Central Asia (78 cases or 4 percent).

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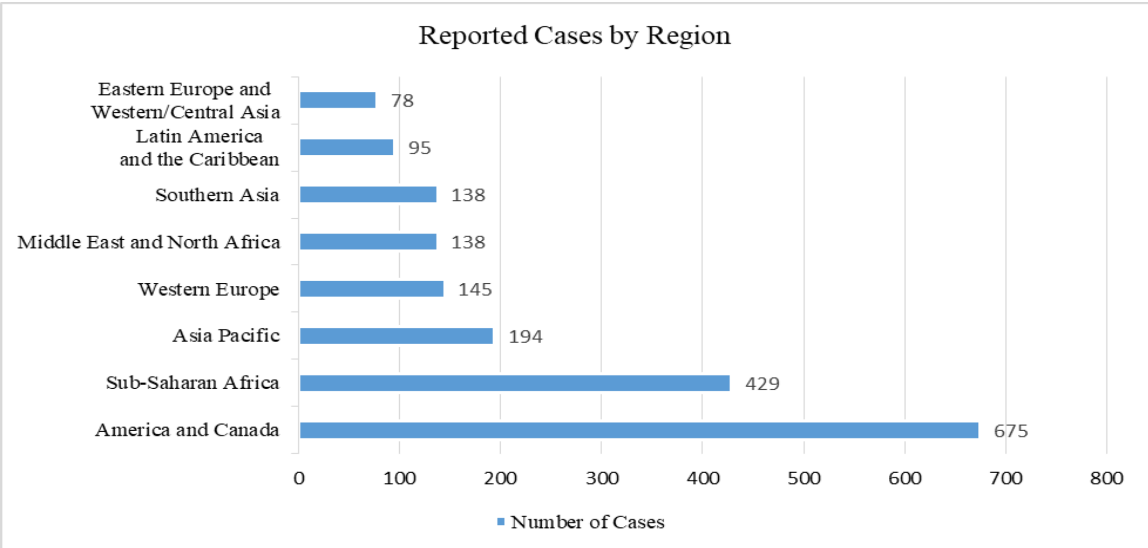
Figure 1: Reported Fraud Cases by Region



Source: ACFE (2022)

Existing research has looked into a number of different aspects of corporate fraud, including managerial incentives (Burns & Kedia, 2006; Efendi, Srivastava, & Swanson, 2007), opportunities, and consequences (Cohen, Ding, Lesage, & Stolowy, 2011; Erickson, Hanlon, & Maydew, 2006; Karpoff et al., 2008; Muhammad Aiman & Tuan Nooriani, 2017), the likelihood of detection (Dyck, Morse, & Zingales, 2010; Wang, 2013), and connections between top executives and the board of directors (Karpoff et al., 2008; Palmrose & Scholz, 2004). Though it can be committed in various ways, all types of fraud can be fatal for smaller businesses. Accounting fraud in large corporations, where a company's financial accounting records are altered to present an image of high revenue and profits when compared to the actual financial results, is considered a red alert for the company. Such misdeeds, which typically involve sophisticated methods of misappropriating or attempting to deflect funds, overstating earnings, understating expenditures, overstating the value of corporate assets, or underreporting the existence of liabilities, will invite investigation from government oversight agencies such as the Securities and Exchange Commission and will have a negative impact on company reputation, revenue, stock market, and interests. Consequently, fraud within an organisation is a concern for all businesses, regardless of size, industry, or location. Due to its potentially harmful influence on businesses, corporate fraud has significantly garnered a lot of attention globally. In the relevant literature, the full repercussions of fraudulent activities have not been thoroughly investigated. As long as the company is operational, some of the effects will persist. The purpose of this study is to examine the major negative effects of corporate fraud discussed in the relevant literature.

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2. Methodology

This study adopted the basic literature review, which is a generic term for a summary of the evidence on a particular subject. Basic literature in academia can be quite simple or extremely complicated, and there are numerous ways of finding, evaluating, and presenting information (Kowalczyk & Truluck, 2013). Depending on the research topic, the purpose of a literature review might vary from being broad and descriptive to answering a specific question. A basic literature review can inform the background of articles and reports to give the reader an overview of the topic. This strategy might be narrow, such as examining the effect or relationship between two specific factors, or broad, such as studying the collective evidence in a certain research field (Baumeister & Leary, 1997). In addition, literature reviews are valuable when the objective is to provide an overview of a particular topic or research subject (Snyder, 2019). This form of literature evaluation is typically conducted to assess the current level of knowledge on a certain topic. It can be used, for instance, to build research agendas, identify research gaps, or simply discuss a specific topic (Tranfield, Denyer, & Smart, 2003). Despite the fact that a basic literature review is a rather loose method, several criteria have been set for this study in order to locate, evaluate, and present data regarding the reviewed studies. This study mainly relied on the Scopus database of business ethics, finance, management, and corporate governance, where pertinent studies on corporate fraud were published. This paper also utilised several existing cases to develop the research and tie it to the contagion effect of the company's fraudulent activity. Also, before deciding the main point of the study's discussion, this paper analysed past fraud cases to determine the worst effects of business fraud on the company.

Table 1: Selected Cases that formed Main Theme of Study

Selected Reference Fraud Scandals	Negative return/ Penalty	Dismissal/Issues of Job Loss	Corporate Social Responsibility (CSR) Issues	Cost of Capital and Low Investment	Low Market Evaluation
Enron	Yes	Yes	Yes	Yes	Yes
Toshiba	Yes	Yes	Yes	Yes	Yes
Lehman Brothers	Yes	Yes	Yes	Yes	Yes
AIG	Yes	Not determined	Yes	Yes	Yes
Satyam	Yes	Yes	Yes	Yes	Yes

Source: Author elaboration

Table 1 displays an indicator of the major themes discussed in this study, derived from a case study of a previous major fraud scandal that shook the world and was considered the most prevalent and threatening to the company after the exposure of fraud issue. Based on the case analysis, it is clear that all companies are penalised under the law and have suffered losses due to the fraud exposure. Employees fear losing their jobs and some companies are forced to lay off workers to meet the shortfall. Companies that restructure and divest their business units suffer significant losses and layoffs. Concerning CSR issues, the fraudulent company is deemed irresponsible by committing fraud, which indicates they intend to commit fraud and disregard their social duty. The terms "cost of capital" and "low investment" refer to the expectation that earnings from the investment will be disrupted and they will not be able to make good investments due to the shortfall in funding. Lastly, when it comes to the value of a company's stock, all fraudulent companies see a sharp drop in price after an investigation by the authorities.

3. Discussion

3.1. Negative Returns and a Decline in Reputation

The first public exposure to corporate fraud is correlated with adverse abnormal returns that are statistically significant for the corporations that are accused of fraud (Armour, Mayer, & Polo, 2015; Lee & Gerald, 2008; Karpoff & Lott, 1993; Murphy, Shrieves, & Tibbs, 2009; Palmrose & Scholz,

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2004). It not only damages the image of the fraudulent company but also widens the knowledge gap that appears to exist between the company's shareholders and management, which makes it more difficult for the company to get more funding (Yuan & Zhang, 2016). As a result, the disclosure of corporate fraud may lead to a decrease in corporate finance. The exposure of corporate dishonesty may set off a chain reaction that is very detrimental to the corporation and can, in the end, result in the failure of the corporation to remain profitable. The worst case leads to the bankruptcy of the corporation. Evidence from the Enron case suggests that the corporation may not be able to finance all lucrative investments, which might lead to a fall in corporate investment, the destruction of the company's name and image, high turnover, and, eventually, a situation in which the company is bankrupt. Enron proposed a takeover bid with smaller cross-town competitor Dynegy on November 9, 2001, but Dynegy rescinded it on November 28 due to Enron's lack of full disclosure of its off-balance-sheet debt, lowering Enron's rating to junk. On November 30, the stock closed at an incredible 26 cents per share. On December 2, the company filed for bankruptcy. In another case, after decades of success, Toshiba faced a financial scandal in its energy division, resulting in a total loss of US $2.14 billion (over seven years ending March 31, 2015). Toshiba's internal audit department discovered the manipulation of profits and other balance sheet figures in April 2015. As a result, the CEO, Vice Chairman, and seven directors resigned. The negative ROE (-3.5%) reflects investor disappointment in 2015. When the power sector scandal became public, they got a lot of backlash from the public and a negative ROA (-0.5%), which shows that Toshiba's ability to use its assets is going down.

Another fact that has been proven beyond a reasonable doubt is that the losses suffered by a company accused of misbehaviour cannot be adequately explained by legal punishments. It is one of the perpetual losses to the corporation, as the legal suit remains in address. It has been shown that the loss of the firm's reputation, apart from the legal consequences, plays a significant influence in the penalty meted out to the corporation. Legal sanctions refer to any fines, fees, or penalties that the corporation is required to pay as a result of the court's decision. For instance, in Malaysia, if the corporation is exposed to practising fraud, it will be fined under the Corporate Liability Provision under Section 17a of the MACC Act 2009; if a commercial organisation commits an offence, it may be subject to a fine of not less than 10 times the sum or value of the gratification that is the subject matter of the offence, where the gratification is capable of being valued or is pecuniary, or RM1, 000,000, whichever is greater. Alternatively, the commercial organisation may be sentenced to a term of imprisonment not exceeding 20 years, or it may be subject to both options. For instance, Toshiba was the target of several lawsuits filed by individuals and groups of investors who claimed that their decisions in the past (between 2008 and 2015) were based on Toshiba's financials. According to a reliable source, 45 overseas institutional investors have filed a lawsuit seeking 16.7 billion yen in damages since the company first admitted to reporting inflated profits in 2008 (Taiga & Makiko, 2017). In addition, 15 groups and individuals in Japan have filed suits totalling 15.3 billion yen. Also, the company was fined $60 million by Japanese regulators.

In addition, corporate fraud will influence creditor/supplier engagement with the exposed fraud company as a result of the company's damaged reputation and lack of confidence in its ability to fulfil contract terms. According to Armour et al. (2015), in a business transaction, reputation refers to "partners' future expectations about the benefits of doing business with it." This is an essential part of all businesses. The market’s decision to impose this penalty on the corporation may be justified by the possibility that the company will not be reliable in the near future. Such revisions to the estimates would have a future impact on the trade and the organisation’s expenses and operations. Typically, a dishonest company will have poor financial health, which may hinder its ability to pay its creditors. This may prompt creditors to impose stringent supply requirements for future contracts, making it more difficult for the company to meet such requirements. These unfavourable changes in the prices of inputs and outputs would reduce the company's profitability and, consequently, its market value (Jarrell & Peltzman, 1985; Klein & Leffler, 1981).

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3.2. Issue of Attrition/Turnover of Human Capital

The term "capital" is frequently described as "assets accessible for use in production, wealth in the form of property, and a centre linked with some activity." According to Awalluddin (2019), human capital is a skill a person possesses that allows them to be more efficient and productive than regular individuals. Individuals can gain such abilities through education, health, and training offered by their employers. Most of the time, unethical behaviour is shown to be bad for an employee's career. Scholars state that companies with good social performance tend to do better financially by attracting socially responsible customers (Bagnoli & Watts, 2003), reducing the threat of regulation (Lev, Petrovits, & Radhakrishnan, 2010), improving their reputation with customers (Orlitzky, Schmidt, & Rynes, 2003), or addressing the concerns of activists and non-governmental organisations (Baron, 2001).

However, ethical behaviour and legal compliance are not always advantageous to employees' careers. Customers in some industries may demand behaviour that violates existing laws and harms society as a whole, a condition known as unethical demand. Unethical demand for fraud is one of the most common types of misconduct in which firms and individuals deceive or misrepresent information. Examples include Arthur Andersen auditing, bars serving underage clients with fake identification, and home appraisers and mortgage brokers fraudulently inflating home values or income on loan applications (Pierce & Snyder, 2013). If ethical businesses fail to respond to unethical demand, they may lose a significant number of customers and employees, either through workforce reduction or voluntary departure owing to uncompetitive pay. For example, restaurant servers may give free food or drinks to customers to increase tips (without telling the manager), store employees may choose not to watch or prosecute shoplifters for bribes or social benefit, and doctors may lie about a patient's health to make it easier for them to get medical care (Snyder, 2010). However, such organisational deviations may have regulatory repercussions, and departing from regulatory requirements may have much more negative implications. This is because ethical businesses are typically more successful. According to the Ethisphere Institute, the global leader in defining and advancing the standards of ethical business practices, Dell, Ford Motor Company, Intel Corporation, Levi Strauss & Company, L'Oreal, ManPower Group, Marriott International, Marks & Spencer, Royal Caribbean Cruises, Starbucks, and Xerox are among the 2016 world's most ethical companies (Albu, Mandru, & Suciu, 2017). All these businesses are doing well, which shows that ethics and business success are related.

Since these major corporations are more successful economically, their employees stay with them longer, meaning they get paid more, have more job security, and have better career opportunities as the companies grow. If employees are misled about the company's prospects during the fraud, they might be negatively affected along with other stakeholders. For instance, over-hiring might cause unsuspecting individuals to suffer later when these excesses are resolved, such as losing job-specific capital or seeking employment under adverse conditions. Existing research also says that a lack of ethics in an organisation will make employees less happy with their jobs and more frustrated, subsequently leading to more turnover (Pettijohn, Pettijohn, & Taylor, 2007; Valentine, Godkin, Fleischman, & Kidwell, 2011). Corporations in financial distress have difficulty hiring new employees and are encouraged to lay off younger staff (Brown & Matsa, 2016; Caggese, Cuñat, & Metzger, 2019). Ultimately, the fraud corporation has negative job growth following the conclusion of the fraud.

3.3. Disengaging CSR

CSR is traditionally defined as the responsibility of corporations to pursue policies, make decisions, and follow courses of action that are beneficial to society's goals and values (Bowen, 1953). Carol (1991) elaborates on this description by stating that CSR encompasses the economic, legal, ethical, and discretionary categories of corporate responsibility that society expects of companies. In other words, corporations must fulfil their economic objectives, comply with legal obligations, and engage in other ethical behaviours that are not mandated by law but are demanded by diverse stakeholders. According to Awalluddin (2020), the fundamental rationale is that corporations operate by obtaining a social licence from society, i.e., by extracting resources from nature and society. Therefore, it is their ethical responsibility to return any social support for social benefit. However, the

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rise of corporate scandals worldwide in recent years has shown that many companies are making money at the expense of society as a whole.

However, the results of past studies on the relationship between CSR engagement and corporate fraud are mixed. For example, Evans, Goodman, and Davis (2011) show that perceived corporate citizenship has a negative impact on employee deviance via organisational cynicism. One school of thought holds that CSR efforts are utilised by self-serving managers to enhance their public image and deceive stakeholders (Li, Kim, Wu, & Yu, 2021). However, Prior, Surroca, and Tribó (2008) and Tran and O'Sullivan (2020), for instance, demonstrate that CSR is positively related to corporate earnings management. Other researchers, however, say that CSR activities show that managers care about doing the right thing, and Kim et al. (2012) found that socially responsible firms manipulate their earnings less.

Additionally, Liao, Chen, and Zheng (2019) found that CSR scores are negatively and significantly associated with firms' propensity for financial fraud, implying that firms with higher CSR ratings are less likely to engage in fraudulent activities. Corporations with a commitment to social responsibility strive to enhance their company brand and meet the ethical standards of stakeholders. CSR is strongly related to the business internal governance framework, which restricts fraudulent conduct opportunities. Furthermore, Lee and Mitchell (1994) argue that internal moral stakeholders, including executives, investors, and employees, tend to stick with ethical and responsible businesses and steer clear of opportunistic ones. From this point of view, CSR activities that portray a strong ethical image for the corporation can decrease managers' propensity to participate in fraudulent actions. In other words, businesses are thought to be socially responsible if they employ socially responsible managers who are prepared to give up some of the company's resources in order to advance socially responsible goals (Godos-Díez, Fernández-Gago, & Martínez-Campillo, 2010). CSR managers believe that ethics and social responsibility are vital to a company's success due to the fact that ethical practices are more concerned with the sustainable value of the company as well as the legitimate interests of all stakeholders. Because of these things, it is thought that socially responsible managers are less likely to do illegal or immoral things, particularly when those things can severely hurt a company's reputation and legitimacy.

3.4. Increase in the Cost of Capital and Low Investment

Corporations that have committed fraud face increased capital costs due to changes in trade terms. Allegations of fraud can lead to contract revisions, including bank loans, which are a major source of funding for corporations. This is due to the fact that the cost of equity is used to calculate the current stock price based on future cash flows. Alternatively, corrupt behaviour could have an impact on the required rate of return for the firm. The study of bank loans enables an understanding of the real financial consequences of misreporting because the implications for debt costs can be assessed directly on interest rates and indirectly on maturity, covenants, etc. According to Yuan and Zhang (2016), fraudulent firms have higher capital costs and invest less in long-term assets. In accordance with previous research, Chapman-Davies, Parwada, and Tan (2014) found that corruption-tainted mutual funds experience a decline in inflows. According to Shang-Jin and Andrei (2000), there is a similar negative relationship between corruption and foreign direct investment.

Evidence supporting the connection between corrupt behaviour and the needed rate of return is drawn from the literature on agency costs and corporate (Boubakri, Guedhami, Mishra, & Saffar, 2012; Chen, Chen, & Wei, 2009). Specifically, in the case of corporate corruption (Qian et al., 2011), politicians have incentives to capture rent and regulators have motivations to apply severe fines, hence increasing systemic risk (Banerjee, Gupta, & Krishnamurti, 2022). Moreover, unscrupulous corporations incur more regulatory risks. They would be exposed to greater systemic risk if the regulation were to be altered. Also, in emerging markets with undeveloped institutions, diversification opportunities may be restricted, hence increasing the cost of unethical corporate behaviour. As the availability of loans generally declines, businesses are forced to rely on short-term funding, which may force them to forego

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certain investment opportunities. This is consistent with Diamond's (1991) theory that debt maturity depends on risk ratings.

3.5. Low Market Valuation/Stock

The reputational effects of fraud are extensive. According to Fich and Shivdasani (2007), even corporations that are simply interlocked with a firm being sued because they share the same directors experience significant valuation decreases when the case is filed. In significant fraud incidents such as Enron, stockholders lost the great majority of their investments (Enron shares fell from $83 to nearly nothing after fraud disclosure) (Healy & Palepu, 2003). Meanwhile, Dyck, Morse, and Zingales (2011) estimate the average corporate fraud costs to be as high as 22% of the firm's total value.

Karpoff and Lott (1993) performed the first substantial investigation into corporate fraud in 1993. After researching 132 incidents of corporate fraud in the U.S. market, the researchers discovered that firms convicted of fraud risk enormous reputational costs compared to legal penalties. Only 6.5% of a company's losses may be attributable to court-imposed costs and 1.4% can be attributed to penalties; the remainder, over 90%, can be attributed to reputational losses. Also, corporate fraud makes the value of common stock drop by an average of 1.34 percent. One of the causes of market devaluation is the decline in public confidence in dishonest corporations and poor ratings. While the sentiment of financial losses suffered by investors or shareholders stays unchanged, other losses are added, such as the loss of future investors or shareholders, resulting in a decrease in the corporation's stock valuation. For instance, when the Securities and Exchange Commission (SEC) discovered the scam in early 2003, HealthSouth stock fell from about $100 per share to less than 15 cents in a single trading day. Consequently, it was delisted from the New York Stock Exchange (NYSE). In 1997, Bre-X Minerals supposedly discovered the world's largest gold mine in Indonesia. The stock price soared to about $300 per share, and many investors who sold around the peak made a fortune. Unfortunately for the remaining Bre-X investors, the massive gold discovery turned out to be an elaborate deception. Almost immediately, the stock reverted to its status as a penny stock after the scam was uncovered. Consequently, the depiction portrays the discovery of fraud resulting in a substantial decrease in the corporation’s market value and, in the worst-case scenario, the declaration of bankruptcy.

Figure 2: Enron's Stock Price Plummets

Source: Wikimedia Common (2015)

4. Conclusion

Recent fraud scandals have elevated the fraud issue to the forefront of economic and financial concerns. Fraud risks surround businesses. Each organisation is susceptible to fraud from its personnel, regardless of rank or tenure, and in many instances, internal and external fraudsters work together. The existing literature has served as a reference for comprehending the damaging effects of corporate fraud.

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The fraud issue should not be downplayed since its repercussions endanger not only the existence of the organisations but also industry policy. The disclosure of fraud motivates the government to implement strict rules and revise the law, thus requiring corporations to meet stringent governance requirements. In addition, corporations with fraud scandals must face legal repercussions on both sides, which cause certain problems, such as legal suits from employees and creditors. Despite the fact that they may have survived, they will be branded as problematic and new investors will be hesitant to invest in them. Competent human capital will exercise caution before signing a contract with them. Hence, there is a high probability that the corporations will become less attractive and will be unable to compete in the market. As fraud activity is difficult to combat, the paper recommends that corporations enhance their internal controls, conduct frequent job rotations, and focus on top management, as the majority of fraud is committed by top management due to their advantageous circumstances.

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