

INTERNAL CONTROL, CORRUPTION AND MONEY LAUNDERING¹

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Abstract

The global financial crises created a different context for the economic growth and globalization. In the last few years, five risks have been designated as "risks to watch", as survey respondents assessed them with high levels of variance and low levels of confidence while experts² consider they may have severe, unexpected or underappreciated consequences: cyber-security, demographic challenges, resource security, retrenchment from globalization, weapons of mass destruction. Strongly connected to these risks others are important to analyze: corruption, illegal trade and money laundering. There is a strong relation between corruption and money laundering. During the economic crunch the level of corruption and fraud had scientifically increased.

Internal control could be a good instrument to reduce corruption and to stop the illegal trade and money laundering. Internal control is a dynamic integral process that is continuously adapting to the changes an organization is facing.

Key words: *Internal control, corruption, money laundering*

JEL Classification: H₈₃, M₄₁, M₄₂

1. Introduction

This paper seeks to present an analyze of the current literature by examining the negative welfare effects of corruption, the interaction between political connections and the effect of corruption, and the causes and consequences of corruption. In the present paper, I present the relation between internal control, corruption and anti-corruption procedures. Corruption represents a barrier of the economic development and stability all over the world. As outlined in the Forum's Financial Development Report 2010, strengthening financial systems in emerging economies by developing capital markets and improving access to retail financial services could increase both domestic confidence and investment opportunities,

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² www.weforum.org – The Global Risks Report 2010-2011.

both of which could stimulate consumption and help to offset global imbalances as well as reduce the risk of asset bubbles.

Olsen³ presented corruption as a negative phenomenon with a corrosive impact on both overseas market opportunities and the broader business climate. Corruption deters foreign investment, stifles economic growth and sustainable development, distorts prices, and undermines legal and judicial systems. More specifically, corruption is a problem in international business transactions, economic development projects, and government procurement activities. The effectiveness of a government's anti-corruption measures may affect the incentives for corporations to seek political benefits.

2. Literature review

The paper has based its conclusions on the following papers and researches: COSO, Committee of Sponsoring Organizations of the Treadway Commission (2009) "Internal Control – Integrated Framework" presented how ongoing and/or separate evaluations enable management to determine whether the other components of internal control continue to function over time, and internal control deficiency are identified and communicated in a timely manner to those parties responsible for taking corrective action and to management and the board as appropriate. "Over the past decade, organizations have invested heavily in improving the quality of their internal control systems. They have made the investment for a number of reasons, notably: (1) good internal control is good business – it helps organizations ensure that operating, financial and compliance objectives are met, and (2) many organizations are required to report on the quality of internal control over financial reporting, compelling them to develop specific support for their certifications and assertions."⁴

Bishop and Kidosky present in their book "Corporate Resiliency" how to manage the risk of fraud and corruption. "Fraud itself cannot be eradicated, but fraud and corruption risks can be managed like other business risks. Fraud and corruption risk management strategies can help companies avoid some frauds and help them reduce the impact of frauds that occur. Resilient corporations focus more on strategies, not tactics, for managing fraud and corruption risks intelligently. In today's more brittle economy, fraud and corruption can more easily set off a chain of events resulting in significant loss for the companies affected⁵."

Olsen, P. (2010) discussed the new proposed regulations about anti-corruption. In his book "The Anti-Corruption Handbook", he presented managing corruption risk, efforts to combat global corruption, laws governing corruption,

³ Olsen, W. P. (2010), "The Anti-Corruption Handbook. How to Protect Your Business in the Global Market Place", John Wiley & Sons, Inc., Hoboken, New Jersey, p. 26.

⁴ The Committee of Sponsoring Organizations of the Treadway Commission (COSO) – Internal Control – Integrated Framework, p. 2.

⁵ Bishop, T. Kidosky, F. – "Corporate Resiliency, Managing the Growing Risk of Fraud and Corruption", John Wiley & Sons, Inc, New Jersey, 2009, p. 3.

internal control and accounting provisions. “Since the Foreign Corrupt Practices Act (FCPA) was enacted in 1977, U.S. law has prohibited offers, promises, or payments to foreign officials, political parties, political officials, and candidates to secure business. A company running afoul of the FCPA, or recently enacted anti-corruption laws of other countries, may subject itself to criminal charges and substantial fines. Companies in these situations may also face loss of financing and insurance from national or international institutions and debarment from public contracting. Companies committing FCPA violations may also sustain damage to their reputations and their ability to compete for international business. The financial losses incurred due to the loss in reputation can be far more costly than the fine and penalties leveled against companies for FCPA violations.”

Treisman, D. (2000) is explaining why fighting corruption in many countries has proved so difficult and the distant past appears as important as – or more important than – current policy. He thinks that democratization has to be radical and long-lived and trade liberalization has to be extensive to decrease corruption much. “The one slightly more hopeful finding is that, even though corruption hinders growth, countries can at times grow their way out of corruption.”⁶

Svenson, J. (2003) found that firms typically have to pay bribes when dealing with public officials whose actions directly affect the firms' business operations. Such dealings cannot be easily avoided when, for example, exporting, importing, or requiring public infrastructure services. Svenson made the connection between bribes and corruption by the quantitative data on corruption with detailed financial information from the surveyed firms to test his bargaining hypothesis and find that firms' "ability to pay", proxied with their current and expected future profitability⁷.

3. Internal Control

According to the Committee of Sponsoring Organizations of the Treadway Commission (COSO), internal control is designed to assist organizations in achieving their objectives.

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⁶ Treisman, D(2000), “The Causes of Corruption: a cross-national study”, *Journal of Public Economic* 76(2000) p. 402.

⁷ Svenson, J(2003), “Who Must Pay Bribes And How Much? Evidence From A Cross Section of Firms”, *The Quarterly Journal of Economics*, MIT Press, vol. 118(1), p. 209.

⁸ COSO, *Internal Control, Integrated Framework, Guidance on Monitoring Internal Control Systems*, 2009, p. 5.

standard has become one of the principle benchmarks for American companies to evaluate their compliance with the U.S. Foreign Corrupt Practices Act (FCPA).

Internal control is a dynamic integral process that is continuously adapting to the changes an organization is facing⁹. The International Organization of Supreme Audit Institutions (INTOSAI) claims that no matter how well designed and operated, internal control cannot provide management absolute assurance regarding the achievement of the general objectives.

Sullivan & Cromwell LLP maintain that the SEC's interpretive guidance, which addresses the management assessment aspects of the internal control process, emphasizes a top-down, risk-based approach to evaluating the design and operating effectiveness of internal control over financial reporting. Sullivan & Cromwell LLP stress that management should evaluate the design of controls to determine whether the controls adequately address identified financial reporting risks.

As Sullivan & Cromwell LLP put it, support for management's assessment may come from a variety of activities, including day-to-day management of the business, direct testing and activities that are performed to meet the monitoring objectives of the control framework. PCAOB state that the effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes. PCAOB argues that the auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work.

INTOSAI holds that as information technology has advanced, organizations have become increasingly dependent on computerized information systems to carry out their operations and to process, maintain, and report essential information. INTOSAI claims that providing needed information on internal control deficiencies to the right party is critical; information generated in the course of operations is usually reported through normal channels.

COSO observes that no system of internal control can guarantee that all control weaknesses that may result in material errors will be prevented and detected. Hong Kong Institute of CPA writes that establishing a sound system of internal control and reviewing its effectiveness is about implementing mechanisms that will help a company to achieve its corporate objectives and fulfill the expectations of its shareholders and stakeholders. Hong Kong Institute of CPA contends that control is not synonymous with managing and does not constitute everything involved in the management of a company. PricewaterhouseCoopers affirms that the Internal Control System (ICS) is one of the key management instruments at an organization's disposal. PricewaterhouseCoopers maintains that the investment an entity needs to make in setting up and operating its Internal Control System depends on the objectives and the desired scope of the ICS.

⁹ INTOSAI, Guidelines for Internal Control Standards for the Public Sector, p. 6.

4. Corruption and money laundering

Corruption is a growing phenomenon and many specialists discussed its evolution. Bishop and Kidosky¹⁰ present in his book “Corporate Resiliency” how to manage the risk of fraud and corruption. Thus, “ongoing legal and regulatory requirements, board pressure, and increased media coverage have created a new sense of urgency and have raised legitimate questions about whether companies are prepared to deal effectively with the complexities of fraud in a global economy. For example, despite the fact that the Foreign Corrupt Practices Act (FCPA) has been around for years, it has only recently become an issue for many companies. Prosecutions of FCPA violations have increased rapidly over the past several years, due to increased focus by U.S. and other authorities on anti-corruption. Several years ago, bribery violations would not have been on the horizon as major risk concerns. Today, for companies dealing with officials in other countries, they can be paramount, thanks to recent international fines and penalties as high as \$ 1.6 billion for a single company.” They think that the unnerving speed at which new fraud risks appear and grow seems to argue for a new kind of corporate agility based on risk management processes supported by advanced analytical technologies. These newer technologies enable companies to develop forward – looking capabilities for anticipating and responding quickly to new risks as they emerge.

As DiRienzo¹¹ et al. developed an interesting relation between corruption and taxes. They think that corruption raises the cost to host countries in the form of reduced tax revenues. This is why corruption has a negative impact on a country’s ability to become a significant player in the global economy. A normal consequence is a more open and transparent economy experiences a lower level of corruption. As a result, openness in public and private institutional operations should reduce the prevalence of corrupt practices. The conclusion is that access to information lowers corruption levels.

Olsen¹² had prepared an anti-corruption handbook. He thinks that money laundering represents one of the most important problems of the global economy. “In an effort to crack down on money laundering transactions, since 9/11 the federal government has enacted new reporting regulations for the banking and financial industry and is planning to extend such regulations to cover money brokers and other businesses and organizations involved in the transfer of large sums of money. The “Suspicious Activity Report” requires financial institutions and other businesses that transfer large amounts of cash to report patterns of suspicious activity by customers.”

¹⁰ Bishop, T. Kidosky, F., “Corporate Resiliency, Managing the Growing Risk of Fraud and Corruption”, John Wiley & Sons, Inc, New Jersey, 2009.

¹¹ DiRienzo, C. et al. (2007), “Corruption and the Role of Information,” *Journal of International Business Studies* 38: 320–332.

¹² Olsen, W. P. (2010), “The Anti-Corruption Handbook. How to Protect Your Business in the Global Market Place”, John Wiley & Sons, Inc., Hoboken, New Jersey, p. 24.

Olsen discussed the new proposed regulations also call for the development of “Customer Identification Programs,” which call for financial institutions to establish procedures and adopt steps to reduce the risk of money laundering under the Bank Secrecy Act, Patriot Act, and other anti-money laundering laws. He admitted that if implemented correctly, these preventive measures should help financial institutions prevent and detect illegal activity being perpetrated against their organization. It will also assist them in complying with government regulations.

Chaikin and Sharman¹³ presented some anti-corruption techniques and the relation between corruption and money laundering. Anticorruption techniques can potentially assist in the fight against money laundering. Reporting entities routinely fail to lodge information about corruption-related transactions. Chaikin and Sharman say that corruption and money laundering will often occur together, mutually reinforcing each other, and they will affect the economic development.

Corruption and money laundering had a big impact on governments, on society, population and a special impact on business. Since 2006 the World Economic Forum’s Global Risks report has provided a unique and timely analysis of the risks that are shaping the global environment. Corruption is one the risks discussed on the World Economic Forum 2011. Illicit trade, organized crime and corruption are chronic risks that are perceived as highly likely to occur and of medium impact¹⁴.

5. Conclusion

The negative effects of corruption, illicit trade and money laundering are easy to characterize but extremely difficult to quantify. Governments are making efforts to reduce corruption and the effects of money laundering. According to the World Economic Forum 2011, the financial crisis has reduced global economic resilience, while increasing geopolitical tension and heightened social concerns suggest that both governments and societies are less able than ever to cope with global challenges. Internal control could be an efficient instrument to reduce the corruption, illicit trade and money laundering. Companies’ management should implement the internal control and the good internal control it means good business.

The COSO Board recognizes that management’s assessment of internal control often has been a time-consuming task that involves a significant amount of annual management and/or internal audit testing. Thus, effective monitoring can help streamline the assessment process, but many organizations do not fully understand this important component of internal control.

Olsen¹⁵ thinks that an effective anti-corruption program must have the foundation of a strong code of conduct that communicates the organization’s position

¹³ Chaikin, D. and Sharman, J.C. (2009), *Corruption and Money Laundering: A Symbiotic Relationship*. New York: Palgrave Macmillan, p. 45.

¹⁴ www.weforum.org – The Global Risks Report 2010-2011.

¹⁵ Olsen, W. P. (2010), “The Anti-Corruption Handbook. How to Protect Your Business in the Global Market Place”, John Wiley & Sons, Inc., Hoboken, New Jersey, p. 25.

on conflicts of interest, bribery, kickbacks, confidentiality of proprietary information, and compliance with all applicable laws and regulations. To be effective, the program must have the support and oversight of top management. The communication of the organization's policies and procedures is also critical in this type of program. More than that, employees need to be constantly apprised of industry trends and new regulations through ongoing training programs.

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