

Application of the theory of changes in the development of anti-fraud schemes

Vasilisa Makarova^a

^a National Research University, Higher School of Economics, 194100, Russia, Saint-Petersburg, Kantemirovskaja street, b. 3a., room 307, vmakarova@hse.ru

Abstract

In this article we provide the results of a study on measures to prevent fraud in different countries. The article shows that the level of fraud in Russia is quite high. This is due to the low culture of doing business and the high bureaucratization of government authorities. Creating transparent schemes of interaction will help reduce the number of fraudulent schemes and build society. The article presents an algorithm for creating a non-fraudulent society using the theory of change.

Keywords: theory of change, fraud, non-fraudulent society

1. INTRODUCTION

Fraud was and remains one of the most acute problems of modern Russia and is a serious obstacle to the development of the country. Fraud undoubtedly damages the growth of the economy and the social stability of the country, significantly reducing revenues to budgets of various levels, displacing honest competitors from the market and reducing the level of public confidence in government bodies and representatives of social and financial structures.

Fraud is a large-scale problem that concerns every one of us, because this is one of the reasons for the decline in the standard of living of the population. It affects us, even if we do not face it directly. 'The risk of fraud and corruption destroys the reputation of the company in society. This risk should be viewed on a par with the health and safety threat to employees and the public, because the effect of its implementation is almost the same - loss of reputation, financial consequences and problems with corporate ethics' [1]. The most common types of fraud, experienced by government or state-owned enterprises, are the following: asset misappropriation, accounting fraud and bribery or corruption.

Concerning Russia, the research of the Economist Intelligence Unit revealed that one of the main obstacles for cooperation between foreign companies and Russian companies is corruption (28% of respondents expressed concern about this issue). The research group Public.ru revealed that in 2012 the amount of damage caused to the state budget by fraud amounted to around 34 billion rubles, of which 31 billion rubles related to the Moscow region.

The main feature of the Russian practice of fraud in the field of government or state-owned enterprises is that most cases are concentrated at the level of senior and middle management. The share of lower management and ordinary citizens is negligible in comparison with those mentioned above. The bureaucratic apparatus of Russia is inflated to such a great extent that practically all spheres of life are permeated with fraud. If we eliminate corrupt authorities, it will create other problems. Therefore, the problem should be addressed. It is important to apply correctly the methods of elimination.

In theory, as a rule, the following approaches to fighting fraud are distinguished:

1. The adoption of laws toughening punishment.
2. Increasing the income of officials.
3. The creation of competition (which will reduce the potential profit from this crime).

In terms of tools for countering fraud in the field of government or state-owned enterprises, it is possible to identify external and internal oversight mechanisms. Internal mechanisms act by stimulating a clear delineation of the duties performed. The supervision of authorized bodies is carried out by officials who work autonomously. The external mechanism operates independently of the executive authorities. For example, such means of control can be the judicial system, the media and freedom of speech.

The most effective methods are as follows: the promotion of negative attitudes of the population towards corrupt behaviour, the enhancement of a culture of business communication, the promotion of transparent schemes of doing business and preventive checks of counterparties. A general increase in the financial and legal literacy of the population is crucial in combating various fraud schemes. Currently, the population has a sufficient number of sources of information based on which it is possible to judge the legitimacy and reputation of certain entities. Among these are open databases of tax authorities, open legal online consultations, regulatory and legislative bases and open databases of court sessions on the economic issues of specific firms. All these should be used if one wishes to protect oneself from possible involvement in fraudulent schemes.

Inspections of potential counterparts act as a preventive measure against fraud. The analysis of the reporting to be disclosed by such special methods as the Beneish M-Score reduces the likelihood of the issue of fraud arising. The Beneish M-Score helps to uncover companies who are likely to be manipulating their reported earnings. Manipulations with reporting are an 'easy' form of accounting fraud which is difficult for external users of reports to identify; at the same time, internal control services are generally not interested in identifying it – whether or not it exists. Public reporting is both an information base for decision making for potential investors of a firm and existing shareholders and an object for due diligence on the part of tax authorities.

An example is a metallurgical plant in Magnitogorsk (MMK). This company demonstrated quite good results for financial management [2], a high degree of maturity in risk management [3] and high value-based indicators [2], but it was revealed using the Beneish method that its financial statements were subject to manipulation. The M-Score was -1.89, classifying the firm as a manipulator when it actually was not engaging in manipulation. The Beneish M-Score is a probabilistic model, so it will not detect manipulators with 100% accuracy [4], but these results indicate that stakeholders need to examine how the company conducts its business. The company seeks to present a positive outlook by manipulating reporting, but in the long term a relationship with such a company would lead to a loss of value at the very least and in the worst case to penal situations, loss of reputation and value.

Benchmarking of the internal control systems of Russian energy companies revealed that management not only does not prevent fraud, but rather often (47% of cases) resort to it, with the goal of solving problems at the pre-trial level. Another and quite significant direction of economic fraud concerns activity at the level of representatives of different governmental power in Russia. Among these, it is possible to distinguish lobbying for personal interests in support of legislative projects, misappropriation of assets and tax fraud.

The length of this paper does not permit disclosure of the depth of this problem, or even a means to influence the situation in the country, but it should be noted that with the development of information systems and the Internet, the number of offenses is decreasing. Transparency and measures for tightening legislation reduce the amount of economic fraud at the level of middle management. In addition, the non-profit organization the Anti-Corruption Foundation was established in 2011 by the activist and politician Alexey Navalny.

The FBK carries out investigations into corruption by Russian authorities. It is taking measures to prevent the misappropriation of budget money. Also, the FBK helps people ensure authorities work in the appropriate way to provide normal conditions in the fields of the utilities sector, transport, roadways, elections, etc. Over six years, it has exposed around 30 cases of fraud at different levels governance and has presented the results in the mass media.

Special attention should be paid to lobbying for personal interests at the level of public programmes or strategic industries. For example, any measures aimed at supporting private entrepreneurship in agriculture would never work because there is just no market. Almost the entire agricultural industry has long been concentrated in the ownership of one person, giving rise to the opportunity to take advantage of the preferential lending rate applicable to agricultural enterprises, the ability to set prices for the purchase of raw materials and to regulate the range of products. All regions face similar challenges in delivering sustainable transport solutions to meet their current and future mobility requirements. Transport authorities are aware of the real needs specific to their region, but often find it difficult to identify detailed information on targeted solutions that would deliver direct and tangible positive outcomes.

1.1. Fraud as an object of scientific research.

The analysis of fraud and development of methods to combat it have attracted special attention from researchers since the late 20th century and into the early 21st century. Due to the large gap in income between developed

countries and developing countries, international assistance programmes have been implemented for poor countries. When analysing their implementation, shocking facts concerning inefficiency have been revealed due to corruption in low-income countries, which has led to the misappropriation of a significant part of international aid by local corrupt elites [5, 6, 7, 8].

Brown and Cloke studied the effectiveness of the neoliberal approach in fighting corruption [9, 10]. When asked about the functioning of corruption mechanisms in countries with economies in transition, the authors tried to give an anthropological answer [11]. The effectiveness of the proposed methods for combating corruption has been investigated by a number of scientists [12, 13, 14, 15]. Hough also studied successes in the fight against corruption using the examples of Bangladesh and Kenya. An attempt to combine the description of corruption practices in a large number of sectors of the economy was undertaken in work carried out under the auspices of the World Bank [16].

As the study of the problems of illegal migration in Russia has shown, this phenomenon is closely linked to corruption and the shadow economy sector. An analysis of the cultural basis of corruption in Russia and informal networks, including the state and the evolution of the so-called 'system', was conducted by Ledeneva [17], revealing the existence of informal rules and links, often more important for making real political or economic decisions than formal laws or even a hierarchy of governance. The quintessence of these 'conceptual' laws is reflected by Pastukhov's work.

Quantitative estimates of corruption in Russia are given in the work of Satarov [18]. Mathematical models of corruption were proposed by Levin [19], whose work singled out both negative and positive effects of corruption for the economy and built mathematical models of its influence on economic development. An assessment of the state and dynamics of domestic corruption in Russia, including in the regional context, was provided in a joint study by the Ministry of Economic Development and the Public Opinion Foundation (2011). The most comprehensive analysis of the study of corruption in economic theories is contained in the work of Glinkina [20], which showed how the economic policy pursued in Russia during the transition period has progressed in line with corruption. Glazyev noted the lack of accountability of the Russian government with respect to society. In addition, it is worth noting the works of Babenko [21] on the historical preconditions of corruption in Russia, Boldyrev [22] aiming to comprehend post-Soviet Russian capitalism and Yakovlev [23] on the connection between state capitalism and corruption in Russia. Inozemtsev showed that in Russia a 'corrupt civilization' has practically been formed.

1.2. Theory of change approach

Most cases of fraud, in the opinion of researchers, arise from the lack of a culture of business management. A rather interesting approach to preventing misinformation is afforded by the theory of change (ToC). This theory allows stakeholders to be oriented to solving problems using a systemic organizational approach. Scientists studying the ToC have stated that the key reason complex programmes are so difficult to evaluate is that the assumptions inspiring them are poorly articulated. Weiss argued that stakeholders in complex community initiatives are typically unclear about how the change process will unfold and therefore pay little attention to the early and mid-term changes that need to happen in order for a longer term goal to be attained. The lack of clarity about the 'mini-steps' that must be taken to achieve a long-term outcome not only makes the task of evaluating a complex initiative challenging, but also reduces the likelihood that all of the important factors related to the long-term goal will be linked [24].

The approach of the theory implies a transformation of inputs by means of activity into tangible outputs, which are summarized in various outcomes. From the perspective of the behavioural economy, outcomes are desirable but not predictable and are of great importance only when resistance to changes (or expected costs) are less than the composition of lost profits, the vision of further development and practical steps [25].

The ToC provides a conceptual framework making connections between different elements, showing how what is done is expected to achieve the purpose and also how 'measures' provide information to help judge the whole exercise. Audits address whether the programme is using resources adequately and is being implemented as planned. Formative evaluations inform ongoing programme implementation management, which is important – especially in participatory initiatives – to gauge how different stakeholders carry out their activities.

Outcomes	Long-term	Business reputation growth	Economic freedom of society	Transparent shareholder-oriented system	Ease of doing business		
		Not a fraudulent society					
	Medium	Ease of obtaining the necessary services	The exclusion of any personal or other financial interests interfering with the conscientious fulfilment of the debt		Continuous improvement		
	Short-term	Reducing opaque interaction patterns	The elimination of unnecessary administrative barriers to economic development.	Economic and/or managerial knowledge	Creation of ethics and culture of a non-fraudulent society	Minimization or elimination of the conditions creating both an incentive and the possibility of a person declining to commit corrupt acts	
Outputs	Disclosure of the facts of corruption and the results of investigations	Reducing bureaucracy	Monitoring data and protocol control	Creation of training tools for officials	Limiting the ability to work and enjoy social benefits	Disciplinary sanctions	
Activities		Research and development	Creation of transparent schemes of interaction	Reporting limitations	Diversification of responsibilities	Policy and funding infrastructure	
		Identification, prioritization and disclosure of economic fraud schemes	Declaration of property and income	Continuous improvement	Increasing the literacy of society	Tightening of preventive measures	

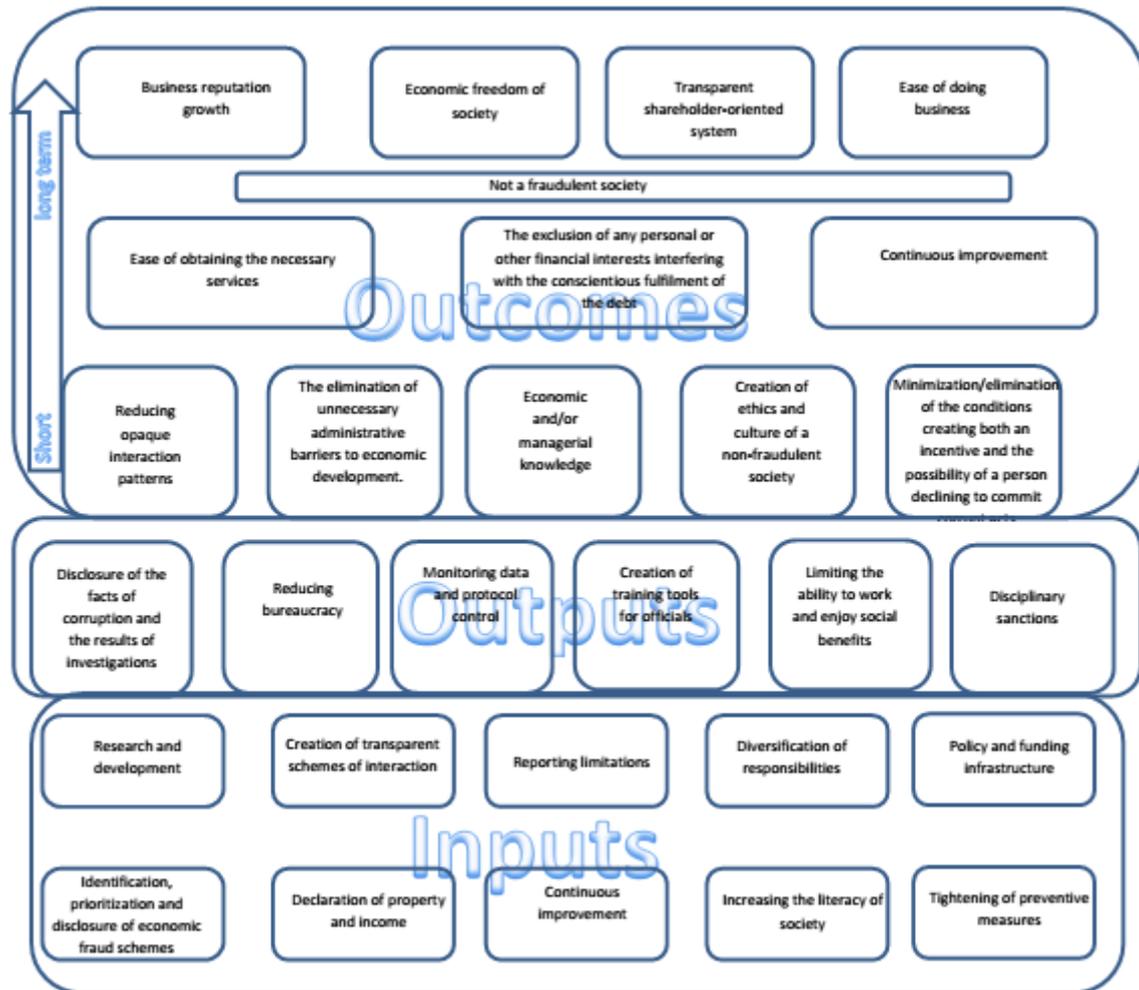


Table 1. Logical model for building a non-fraudulent society

Based on the results of studying the experience of developed countries, the study developed an algorithm of the important steps required to achieve the desired vision. The elements, presented in Table 1, have a recursive rather than a unidirectional influence. The development of higher level outcomes will often interact with the implementation of lower level activities and outcomes. Many activities and lower level outcomes will contribute to the realization of multiple higher level outcomes, which represent the desired changes in the real world. This reminds us that evaluating the progress of any individual activity or outcome is often more about assessing contribution, rather than direct causality.

Despite the large number of works devoted to the study of corruption, we believe that a comprehensive, systematic approach to the study of Russian corruption is promising. It should be viewed not as a historical phenomenon or an element of ineffectiveness of state or business management, not only as part of a system of informal relations, but as a cornerstone of the functioning of the Russian economy when corrupt relations are largely its engine; thanks to these the main monetary and resource flows and economic management are carried out. The algorithm developed using the ToC will serve as a reliable tool for this purpose.

References

- [1] Ernst & Young Global Limited. (2010). Fraud and corruption in the mining and metallurgical industries. [http://www.ey.com/Publication/vwLUAssets/Fraud-and-corruption-in-mining-and-metals-2010-RU/\\$FILE/Fraud-and-corruption-in-mining-and-metals-2010-RU.pdf](http://www.ey.com/Publication/vwLUAssets/Fraud-and-corruption-in-mining-and-metals-2010-RU/$FILE/Fraud-and-corruption-in-mining-and-metals-2010-RU.pdf) (Retrieved: 22.07.2017) [in Russian]
- [2] Makarova, V. (2017). Organization of an ERM system in a company and evaluation of its effectiveness. *Financial Risk Management, 1* [in Russian]
- [3] Ramenskaya, L.A. (2015). Otsenka zrelosti sistemy upravleniya riskami kompanii korporativnogo tipa. *Fundamental'nyye issledovaniya, 11*(6), 1232-1236. <https://fundamental-research.ru/ru/article/view?id=39725> (data of retrieve: 02.08.2017) [in Russian]
- [4] Beneish, D. (1999). The detection of earnings manipulation. <https://ru.scribd.com/doc/33484680/The-Detection-of-Earnings-Manipulation-Messod-D-Beneish>
- [5] Szeftel, M. (1998). Misunderstanding African politics: Corruption & the governance agenda. *Review of African Political Economy, 25* (76), 221–240.
- [6] Leftwich, A. (1994). Governance, the state and the politics of development. *Development and Change, 25* (2), 363–386.
- [7] Bracking, S. L. (2009). Political economies of corruption beyond liberalism: An interpretative view of Zimbabwe. *Singapore Journal of Tropical Geography, 30* (1), 35–51.
- [8] Andvig, J. Chr., Fjeldstad, O. И., Amundsen, I., Sissener, T., & Sereide, T. (2000). *Research on corruption. A policy oriented survey*. Oslo: Chr. Michelsen Institute (CMI); Norwegian Institute of International Affairs (NUPI).
- [9] Brown E., & Cloke J. (2005). Reform, governance and corruption in Central America: Exploring the Nicaraguan case. *Political Geography, 24* (5), 601–630.
- [10] Brown E., & Cloke, J. (2004). Neoliberal reform, governance and corruption in the South: Assessing the international anti-corruption crusade. *Antipode, 36* (2), 272–294.
- [11] Haller, D., & Shore C. (eds.) (2005). *Corruption. Anthropological perspectives*. London: Pluto Press.
- [12] Harrison, E. (2006). Unpacking the anti-corruption agenda: Dilemmas for anthropologists. *Oxford Development Studies, 34* (1), 15–29.
- [13] Harrison, G. (2004). *The World Bank and Africa: The construction of governance states*. London, New York: Routledge.
- [14] Hough, D. (2013). *Corruption, anti-corruption and governance*. Basingstoke: Palgrave Macmillan.
- [15] Khan, M. H. (2006). Governance and anti-corruption reforms in developing countries: Policies, evidence and ways forward. G-24 Discussion Paper Series. No 42.
- [16] Campos, J. E., & Pradhan S. (eds.) (2007). *The many faces of corruption. Tracking vulnerabilities at the sector level*. Washington, DC: World Bank.
- [17] Ledeneva, A. V. (2013). *Can Russia modernise? Sistema, power networks and informal governance*. Cambridge: Cambridge University Press.
- [18] Satarov, G. (2007). How to measure and control corruption. *Voprosy Ekonomiki, 1*, 4–10. [in Russian]
- [19] Levin, M. I. (2007). Economics of corruption. *Finansy i Biznes, 2*, 52–71. [in Russian]
- [20] Glinkina, S.P. (2010). The phenomenon of corruption as viewed by the economist. *Novaya i Noveishaya Istoriya, 4*, 3–17. [in Russian]
- [21] Babenko, V. N. (2009). Corruption in Russia: From customs and traditions to the way of life? *Rossiya i Sovremenniy Mir, 4* 44–61. [in Russian]
- [22] Boldyrev, Yu. (2011). Corruption – Systemic feature of post-Soviet Russian capitalism. *Rossiiskii Ekonomicheskii Zhurnal, 2*, 14–34; *3*, 46–54. [in Russian]
- [23] Yakovlev, A. A. (2010). State capitalism, corruption and effectiveness of state machinery. *Obshchestvennye Nauki i Sovremennost, 4*, 18–25. [in Russian]
- [24] Weiss, C. H. (1995). Nothing as practical as good theory: Exploring theory-based evaluation for comprehensive community initiatives for children and families. In J. Connell, A. Kubisch, L. Schorr, & C. Weiss (Eds.), *New approaches to evaluating community initiatives: Concepts, methods and contexts* (pp. 65–92). New York: Aspen Institute.
- [25] Beckhard, R. (1969). *Organization development: Strategies and models*. Reading, UK: Addison-Wesley.
- [26] Van der Geer, J., Hanraads, J. A. J., & Lupton, R. A. (2000). The art of writing a scientific article. *Journal of Scientific Communications, 163*, 51–59.