Loan Frauds and Forensic Audit

There are a variety of frauds that are taking place in various sectors. This article highlights the loan frauds which are hitting the headlines these days. There is ample scope for forensic assignments for Chartered Accountants in this area. The article discusses the definition of fraud in different statutes, loan frauds, fraud prone areas, wilful defaults and early warning signals indicated by RBI and Red flagging of accounts in such cases. To conduct the forensic audit, the broad scope and methodology, auditors' role and contents of the report are also discussed in this article. Read on…

Over a period of recent times, the loan frauds are on the increase. Frauds are different in each context and each type of loan. Let us understand what fraud is. Fraud is defined in Section 17 of The Indian Contract Act, 1872 which is comprehensive. It is defined as "*Fraud means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agent, with intent to deceive another party thereto of his agent, or to induce him to enter into the contract :-*

- *the suggestion, as a fact, of that which is not true, by one who does not believe it to be true;*
- *the active concealment of a fact by one having knowledge or belief of the fact;*
- *a promise made without any intention of performing it;*
- *any other act fitted to deceive;*
- *any such act or omission as the law specially declares to be fraudulent."*

It is also defined in Indian Penal Code (IPC), 1860 as fraudulently means *"a person is said to do a thing fraudulently if he does that thing with intent to defraud but not otherwise."*

IPC 1860 also classified frauds in the following categories:

- Misappropriation and Criminal breach of trust.
- Fraudulent encashment through forged instruments, manipulating of books of accounts through fictitious accounts and conversion of property
- Unauthorised credit facilities extended for reward or for illegal gratification
- Negligence and cash shortages
- Cheating and forgery
- Irregularities in foreign exchange transactions
- Any other fraud not coming under the specific head as above.

The Companies Act, 2013 has also introduced the definition of fraud in explanation to Section 447. As per new law, it is defined as "*fraud in relation to affairs of a company or anybody corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.*"

CA. M. Sivaram Prasad

The author is a member of the Institute. He can be reached at sivarammoturu@gmail.com or eboard@icai.in

In the above three definitions, IPC gives emphasis on "intent" of the person in a fraudulent transaction. It also talks of cheating which may cause damage or harm to body, mind, reputation or property. However, Companies Act specifies that irrespective of wrongful gain or loss, a fraud is an act with intent to deceive to gain undue advantage of the situation. Contract Act definition gives a sweeping provision which encompasses many things by saying "a promise made without an intention to perform it". Interestingly, IPC mentions "Manipulating Books of Accounts". We are coming across all these situations in commercial world and more so in Banking sector for loans.

Loan frauds

Loan frauds are seen in existence in Banks as well as Financial Institutions including NBFCs. Nature of business of the institutions itself is dealing with money in the normal course, and there is an ample scope for fraudulent transactions. Frauds may involve small amount of money or large volume of money. Involvement may be from individuals to organisations including corporates. The involved person may be staff members or outsiders. The nature of involvement may pertain to securities, properties, business transactions, cash, valuables, documents, etc.

An Internal Working Group (IWG) of RBI held wide ranging consultations with various Banks and other stakeholders on the rising trend in loan related frauds in the financial sector and the delay in detection and reporting of such frauds by banks. Based on the recommendations of this IWG, a framework for fraud risk management in the banks was put in place to detect frauds from early warning signals and reporting such frauds by Banks (Refer RBI Circular DBS. CO.CFMC.BC. No. 007/ 23.04.001/ 2014-15 dated May 7, 2015).

Red Flagging of Accounts and Reporting

RBI has indicated to Banks many instances to be treated as Early Warning Signals. The early warning signals should ring a bell in the minds of the Bankers about the health of the account and repeated signals should be treated as possible sickness of the account and becoming NPA. Such accounts should be red flagged and reported to RBI. Among these accounts, there is a possibility of frauds also.

RBI also in their master circular RBI/2015-16/100 dated 1st July, 2015 indicated the omission and commission by borrowers to be treated as wilful defaults. Here, the intent of the borrower is covered to fit into IPC, Companies Act and Contract Act definitions.

Instances of wilful default include:

1. Not honouring the repayment obligation in spite of having financial capacity.
2. Not utilising the funds for the purpose they are made available and diverting for some other purpose.
3. Siphoning of funds and as a result not creating assets for which funds are disbursed for.
4. Misappropriation of assets or disposing of the assets without the knowledge of the lenders.

Psychology of Fraudster

The psychology of a fraudster is like a wheeler dealer attitude, living beyond his means, starting a big project with shoe string budget, diverting funds meant for capital expenditure for revenue expenses and vice versa, scant respect for statutory obligations and defaulting statutory payments, moving with high profile people and diverting funds for political purposes, starting more than one project without establishing in the business, starting chain of companies to avoid the tracking of cash flows and ultimately divert the funds.

A fraudster does not spare even a charitable organisation.

"RBI has indicated to Banks many instances to be treated as Early Warning Signals. The early warning signals should ring a bell in the minds of the Bankers about the health of the account and repeated signals should be treated as possible sickness of the account and becoming NPA."

Fraud Prone Areas

There are many fraud prone areas. Broadly these are discussed as follows:

- **Documentation:** Presenting false documents, submitting fictitious title deeds, false valuation of primary as well as collateral securities, false export and import documentation.
- **Bills:** Passing fictitious bills, fraudulent discounting of bills, fake export documents, opening LCs on the parties

who are not genuine and for the sake of accommodation and getting guarantees from unconnected parties.

- **Investments:** Transactions with brokers, purchasing of/ sale of treasury dealings with counterparties.
- **Submitting false financial statements:** Submitting the financial statements which are not true and are without adequate disclosures and notes, submitting wrong statements of stocks and receivables, inflating sales to get working capital funds.
- **Change of auditors:** Change of auditors frequently to get financial misstatements accepted.
- **Misappropriation of securities:** Selling the stocks and other collateral securities without lender's knowledge, giving fake ornaments as securities.
- **Inflated Capital expenditure:** Inflating capital expenditure and project costs by false invoicing.
- **Forgery:** Forging documents like cheques, title deeds, agreements etc.
- **Security Paper:** Loss of security paper for using fraudulently.
- **Passwords:** Unauthorised persons using passwords and making fictitious entries.
- **Cash:** Large cash withdrawals and deposits.
- **Round tripping:** Taking the disbursal of loans and bringing the same from other parties as equity from domestic as well as external sources.

Why Forensic Audit?

Financial institutions and Banks have been conducting Forensic Audits and Special Audits to unearth the possibility of diversion of funds, misappropriation of assets including collateral securities like stocks and debtors, ascertain the money trail to identify whether money is used for the purpose for which it is disbursed, whether there is diversion or siphoning of funds. There is a difference between financial audit and forensic audit. The earlier one is meant for expressing an opinion on true and fair view of financial statements prepared by the auditee as per the statutory and regulatory requirements, whereas the latter is meant for identifying frauds with sufficient evidences by gathering documents and eliciting information from various parties directly by interviews and the evidences. Reported views may be used in a court of law for litigation or for use of insolvency professional. Auditor may be asked to appear as witness in a court of law.

There is difference between Audit and Investigation. Forensic investigation needs a team of experts in law, criminology, valuation, Information Technology and industry. Forensic Audit by chartered accountants helps further investigation by investigating agencies. The challenges of the auditor are not having powers to investigate, non-availability of information and non-co-operation from the borrower.

"Forensic investigation needs a team of experts in law, criminology, valuation, Information Technology and industry"

Scope and Methodology of Forensic Audit

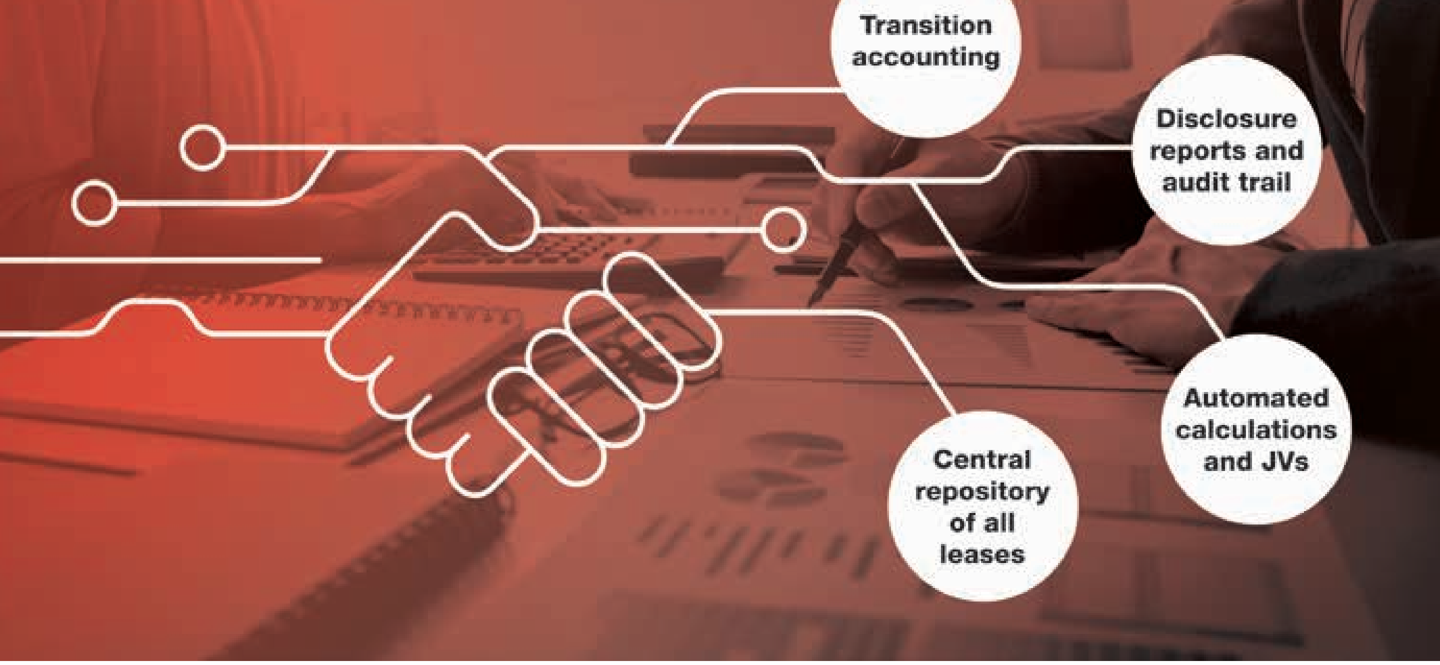
Ministry of finance in its internal circular to banks requires Forensic Audits to be conducted for NPA loans of more than ₹ 50 crore.

There is vast scope to conduct the forensic audit and methodology differs from business to business, but the ultimate aim is to find out the fraud, diversion of funds and their quantification. Broad scope and methodology is:

- During implementation of project, verify the cost of project with industry benchmarks and see whether costs are inflated.
- Whether the capital expenditure is really incurred in relation to land acquisition and development and civil works.
- Whether equity contribution has really come into the company or through loan disbursements to a special purpose vehicle/ EPC contractors are brought back as equity.

LEAZEON

End-to-end IFRS 16 / Ind AS 116 Lease Administration and Accounting Software



Other key features

- Impact analysis of transition of existing leases to new standard with Retrospective and Modified Retrospective methods
- Calculates ROU asset / liability
- Automated depreciation & dismantling provision calculations
- Accounting for lease re-measurements & modifications
- Automated journal entries to your existing ERP
- Maker-checker to ensure accuracy
- Identification of leasing transactions with related parties

TRANSITION DATE
IFRS 16 (Jan 1, 2019)
Ind AS 116 (Apr 1, 2019)

Why wait till the last moment?

Book your demo now!

For more details, please visit **www.leazeon.com**

For demo, please call
Akshay +91 70301 97888 or Arun +91 98220 34590
Send email to sales@leazeon.com

- Verify whether shares allotted for consideration other than cash have real worth
- Whether equity is genuine or borrowed from some other source or a group company
- Ensure that there are no fictitious sales by applying cut off procedures and verify the financial statements of related parties if they are sold to such parties.
- Are there any abnormal trade transactions to inflate profits, stocks or other assets for the purpose of getting working capital funds and writing off the assets later
- Are there any transactions with non-existing, inactive companies or suit case companies
- Verify the findings of any special audit, stock audit, statutory audit, etc. which are relevant.
- Verify the genuineness of LCs specially when they are devolving or Bank Guarantees are invoked
- Verify if there are undisclosed bank accounts through which money is routed
- Verify whether Trust and Retention Account (TRA) is violated and money is routed through other accounts.
- Understand the business of the auditee, business practices, business processes and benchmarks fixed for the line of activity or industry.
- Verify the external evidences like GST Returns, ROC records, Customs duties paid to confirm sales, production and income to understand the fictitious nature and twin balance sheet problem
- Analyse the trend in the last 3 to 5 years with ratio analysis and perform inter firm comparison of similar business.
- Get all the possible information about the personal assets of the promoters, their benamis / relatives.
- Understand the possibility of money laundering within the country or outside
- Is there round tripping of funds within the country and outside the country.
- Verify the relation between possible cash sales and bringing the same as unsecured loans and repayments of the same before lenders commitments.
- Analyse the intercompany transactions in relation to associated / group / sister / companies under same management.

Lender's role

- Red Flagged Accounts (RFA) and reporting to RBI and other agencies like CRILC should be disclosed to Central Statutory Auditors also.
- Lenders should sanction loans on the basis of track record of the borrower and not based on the primary and collateral securities.
- Forensic audit should not be like fire fighting exercise and continuous monitoring by bankers can reduce loan frauds. Monitoring the current account operations by Bankers is like taking pulse rate of a patient.

"Forensic audit should not be like fire fighting exercise and continuous monitoring by bankers can reduce loan frauds. Monitoring the current account operations by Bankers is like taking pulse rate of a patient"

- Funding Politically Exposed Person (PEP) should be avoided and rated as high risk.

Auditor's role

Auditor is a watch dog and not blood hound is an old concept. Now, the role is different and auditor has to not only watch and bark but also chase and catch the thief. Gone are those days of true and fair view especially with forensic audits. With knowledge of business and industry, its practices, auditor should go beyond vouch and post audit and analyse the results of successful companies in similar business and understand input output ratio, production capacity ratio, stock turnover ratio, capital to turnover ratio, cost per employee to sales, consumables to production ratio etc.

Auditor is a watch dog and not blood hound is an old concept. Now, the role is different and auditor has to not only watch and bark but also chase and catch the thief. Gone are those days of true and fair view especially with forensic audits.

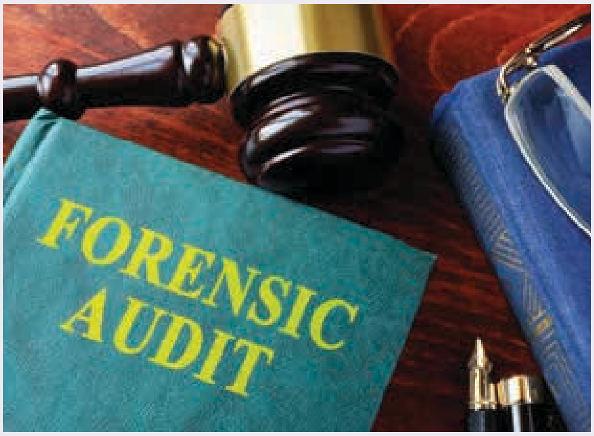
Auditor has to think differently and go beyond financial statements, gather the information, interview concerned people, analyse the data to interpret the announced results, use reports of other professionals to strengthen his views.

Evaluate the fraud prone areas in each type of business and apply audit methodology.

Auditors should understand the identification of wilful defaulters and early warning signals indicated by RBI and take precautions while conducting the audit.

In CARO report, simply commenting on the reported frauds is not sufficient and by applying auditing standards one can identify fraud prone areas and give long form audit report to the auditee.

Central Vigilance Commission (CVC) in consultation with RBI made specific recommendations in critical areas to control frauds. Auditor should be familiar with these recommendations.



Use the technology and Computer Aided Audit Techniques (CAAT) like Generalised Audit Software's (GAS) or Common Software Tools (CST).

Ultimately find if there is diversion or siphoning of funds and quantify the same.

Forensic Audit Report

- There is no specific format for the report. It should cover the scope of the assignment given by the agency concerned.
- Methodology adopted and documents and evidences should be quoted as the basis for making the report.
- Enclose all the evidences as Annexures
- Report the nature of fraud and resultant diversion of funds or siphoning of funds, methodology adopted for committing fraud and also report the interviews sworn deposition for affected parties in the conduct of forensic audit.
- Findings of the audit trail and ultimate reach of funds.
- Report the non-co-operation of the evidences purposefully.
- Report the weakness in the internal controls which lead to fraud.
- Quote the penal provisions of law under which the fraudster can be prosecuted.
- Bring out the instances of misappropriation of assets, falsification of accounts, and non-disclosure of statutory disclosures.
- Quantify the amounts involved in the fraud, misappropriation, diversion and siphoning of funds.
- Give the disclaimers carefully where there is no information / evidences.
- Conclude the report by giving the final findings. ■