

Investigating borrower fraud and diversion of funds

In modern times, risks of lending money seem to be greater to the lenders than the borrowers. A lender's fear of not recovering money from a defaulting borrower is exponentially greater than a borrower's fear of the consequences of not being able to repay loans. In fact there was a very apt joke in a hapless bank where borrower fraud was so rampant. As per that joke going around, when there was a hold up in a bank by a masked robber, asking the cashier to hand over all the money, the cashier replies in a friendly tone that the robber is making a big mistake. He explained to the robber, that it was much safer to take loans from the bank rather than robbing it. This was because by robbing the bank at gunpoint not only was he risking his life, but inviting criminal complaint, police action and eventual imprisonment if caught. In short as a robber he would lead a very troubled life. Further all these risks that he would be taking would be worth just a few stacks of currency notes that he could possibly carry. Instead a borrower without any great effort, much less use of a gun, could get huge amounts of money as loans. Not only that, he could spend up all the money and not worry about any penal action because the extremely slow process in the bank would hardly affect him. Constant changes in bank managers, poor internal MIS and follow up, dragging inquiries and investigations were virtually never ending processes and take their own time. At the end of it, the bank would eventually tire out and would even be prepared to settle for an insignificant small amount which could be easily repaid from the interest and income earned by the robber during the time lost by the bank. This amusing story tells it all.

Thus borrowers are 'kings' and fraud is on the rise. Research and statistics have revealed frightening numbers where not only the quantum of fraud, in terms of the number of cases has increased, but also value of individual fraud in many of such cases reported. Fraud is perpetrated by borrowers in virtually any kind of loan but some of the rampant malpractices, deception, identity fraud and security fraud occur in housing loans, Overdraft/Cash credit(ODCC), Bills discounting (accommodation or non genuine bills), local cheque purchases, etc. In all such cases there is also a very strong possibility of collusion with bank staff. This is because most such borrowers are fully conversant with the bank's internal procedures and sanction requirements and prepare themselves to the minutest details accordingly. They submit proposals after doing full research of the background of the sanctioning managers and establishing contact with them in the bank using services of agents and they are well prepared to do whatever what would be required for the loan. They are prepared to pay a huge cost of 2-3 percent of the loan amount to the agents and in extreme cases, even large amounts to the managers. Amounts are paid separately for sanctions, quick disbursement, and future support to permit temporary overdrafts, permitting unauthorized overruns and exceedings in all facilities enjoyed, turning a blind eye to security deficiencies and overall ensuring that they don't turn into watchlisted accounts or non performing assets.

In this scenario, banks are currently starved of resources, know how, and a structured approach to investigate, understand and recover their moneys from such fraudsters as and when frauds surface. In many cases investigations are carried out by those who may have colluded in the fraud. The results are therefore disastrous. The losses in such frauds even individually in case to case basis do sometimes run

into crores of rupees. The collective or several such frauds in a bank can be devastating. In this regard arresting and sending a borrower to jail is not the solution that a bank really wishes; it is recovery of the money that is important and the key issue. Therefore what banks need is training and awareness of tricks played by borrowers who have defaulted and have perhaps defrauded the bank. What they primarily would need to know is where and how borrowers have diverted their funds to enable them to recover them if possible. This is a major challenge and by no means possible with the limited resources with most banks. A forensic and analytical assessment of the financial statements, and the borrowers business review needs to be done. Professional help is absolutely necessary.

In this context, there are infinite number of ways by which funds can be diverted or used by borrowers, but some of the frequently and commonly used ones are given below:

1. Funds routed, stashed and used from **undisclosed bank accounts**
2. Creation of **latent funds or secret reserves**
3. **Inflating expenditure** for siphoning out cash
4. Omission or suppression of income by having **undisclosed cash** transactions
5. **Diversion of sales and opportunities** to sister concerns
6. Watering down of assets or creating **illusionary assets** to facilitate siphoning out money
7. Creation of **artificial losses** on pretexts of recession, disaster events, etc

Forensic reviews to detect such borrowers' malpractices, (particularly in large value frauds), should be conducted of financial statements available. Such reviews are needed to have a better insight into the flow of funds within the business, whether there was genuinely a loss or whether there was mismanagement and if so, where and how the funds have been used and whether or not they have been transferred outside. In this regard, it is useful to understand how borrowers accomplish their devious means and how perhaps can these be detected. Given below are some methods, which are by no means exhaustive, used by e borrowers to divert or misuse funds. Let us examine each of these methods and try and determine how one could address them.

1. **Funds used in undisclosed bank accounts.** Borrowers can have accounts in banks which may not be disclosed in their financial statements. If the accountants or the auditors are not informed about such bank accounts in use, any amount of diversion can be possible and in huge quantum too. Borrowers resort to this typically when they receive funds from third parties who will pay only by cheque, but they do not want to disclose them immediately to the banks, auditors and accountants. This could be because they may want to use the funds elsewhere which would be not be possible through disclosed bank accounts otherwise. Thus the question before investigators is: How can one find out such accounts? In case of a corporate borrower, the simplest way is to go through the minutes' book of the board of directors. It is mandatory for a borrower to furnish a board resolution authorizing a bank to open an account. In many cases borrowers do pass such resolutions and if so they are actually passed and recorded. Of course a borrower indulging in fraud may not pass such a resolution, but there is a chance that the resolution may be passed. In other cases where there is no such resolution, there needs to be

some test to ascertain whether there are any undisclosed bank accounts. Physical checks, preferably on a surprise basis, of cashiers' drawers for cheque books, pay in slip books, and accountant's offices, if possible, can also reveal such undisclosed bank accounts. Lastly, a lot can be revealed from TDS certificates where details of transactions can be compared with ledger accounts and statement of accounts from customers. TDS certificates received from customers or for payments to vendors may expose some of the transactions in the undisclosed bank accounts. Thus a study of TDS certificates from the point of view of payments and receipts and cash flows can be very effective.

- 2. Creation of Secret Reserves.** Fraudsters do create reserves. This is extremely easy. They may create an artificial payment. For example they may prepare cheques for any vendor or for that matter any other payment, but simply not hand over those cheques to the vendors. In reality the cheques remain with them in drawers. The corresponding funds therefore remain in the bank as there is no cheque presented by any vendor in the banking clearing system. Such funds are called secret reserves which are used clandestinely for other purposes. The natural question that arises is will not every payee ask for these cheques? Well a little reflection on this will throw up several such situations or opportunities available to accountants, where the intended recipient may not even know that he is entitled to receive a cheque, let alone ask for the cheque. For example, donations made may not even be known to the donee organizations. This happened in a case where an amount of Rs 12 lacs was generously donated by workers, which was deducted from their wages in a company to donate to Gujarat Earthquake Relief Fund (GERF). This cheque in favour of GERF was prepared, accounted for in the books and even signed by the company, but never was delivered to GERF. Instead the funds were kept as a secret reserve for the company for its use in future. Similar malafide adjustments and creation of secret reserves can be possible with statutory payments like advance tax, service tax self assessment tax, etc. Such payments are usually computed and made by assesses voluntarily on their own, and there is no receiver waiting for them as such. The concerned departments will only look at or confirm these payments, as and when returns are filed or when assessments are in progress. Till that time if the payments are not made, no one would ever know. Similarly payments for insurance premia can be evaded. No doubt the policies may lapse but this is usually not realized till years later. In all such cases secret funds are created because on records bank balance is reduced through such projected payments, but actually funds are very much there in the bank. This is easily accomplished because in such cases the payment goes to a statutory department- Income Tax or Electricity Board or Insurance company.

What is the best way to detect such secret reserves? The best tool for detection of secret reserves is searching for 'stale' cheques or long outstanding cheques appearing in the 'Bank Reconciliation Statement' (BRS). The BRS is a statement prepared by every entity to match entries in the bank pass book with its own cash book and list out transactions which are exceptions and the reasons for difference between the two balances, if any. Such differences occur due several reasons. One of the common ones is due to cheques issued by the borrower's entity to say, vendors, but not yet presented by the vendor's bank to the borrower's bank. Now if such cheques are issued and not presented for over 6 months, they are not encashable under

the Negotiable Instruments Act, and referred to as 'stale' cheques. These cheques should be accounted for in the books of account as stale cheques which automatically raises the bank balances too. If this is not done, it tantamounts to creating 'secret reserves'. The funds cannot be used by the vendors because of the lapse of the six month validity period. Therefore it is absolutely important to ensure that they have been added back in the books of account in the bank balance as stale cheques. Therefore a keen examination of all BRS of all accounts for stale cheques and similar cheques outstanding for a long time say over a month, are all components of 'secret reserves'. As mentioned before, these could well be lying in the drawers of the cashiers of the borrower's entity.

3. **Inflated expenditure facilitating siphoning out cash.** This is perhaps the most well known and common method and therefore no detailed description is necessary. There are many methods for ferreting out cash through replicated bills, fictitious bills, manipulations in bills. These bills can be detected through audit software and use of Computer Aided Audit Tools (CAATS). In addition there are data validation and audit sampling methods which enable investigators to detect fraudulent bills such as application of mathematical theorems (Benford's Law) or application of 'Relative Size Factor' tests in receivables, payables etc.
4. **Suppression of sales and undisclosed cash collections.** This is the most prolific method used in India and perhaps across the world to suppress and divert income. Not much can be done in this regard except perhaps sting operations and market inquiries from customers and third parties. The presence of clandestine cash dealings can be sensed from several indicators and symptoms. One example is purchase of land or assets where payment of cash is inevitable in almost every part of India. Incompatible sales pricing between customers. For example in a greeting card manufacturing company, sale proceeds received from reputed blue chip companies for cards on comparison with sales proceeds received from medium sized traders for the same products differed significantly. This was found to be true because the reputed companies would not make any payment in cash while traders would want to evade VAT and other taxes and further, they are flushed with cash funds and naturally would want to utilize such cash funds.
5. **Diversion of sales and opportunities to sister concerns.** This is the most difficult to detect unless the investigator has access to the group entities' accounts. However the best way to check this out is to examine the use of assets and billing pattern. A shipping company had ships which were used for coastal services. In one case, a company took a huge loan from a bank and used the money for ulterior purposes. When it defaulted and the bank started inquiring they showed huge losses on account of recessionary conditions. To bring such a loss into their books of account, they had gradually transferred huge sales billings to another group company. In another case cranes at a far off site were rented out to third parties for cash considerations. In another case a fund manager clandestinely started his own investment consultancy service for clients of the broking firm where he was employed. A lot of business was transferred to his private firm where fees were much lower than that of this employer firm, which naturally motivated clients to back him up

To ascertain whether such possibilities exist, more than documentary tests, physical checks and interviews are absolutely essential. Such clandestine activities are more often than not

known or visible to others around. In case of use of assets, common sense tests of reasonableness can be very effective. For example study of crane use log books (eg in case of undisclosed crane hire charges example mentioned above), analysis of drivers' overtime and diesel consumption would give mismatching results on account of the extra usage.

6. Creation of **illusory or redundant assets** to facilitate siphoning out money. In this context, a very resourceful way of diverting funds is manipulations of fixed assets. Land, buildings, fixed assets can be purchased at a high price and when sold they are realized partly in cash. In such situations, there is no method available except for market inquiries, valuation reports, inquiries and verifications with buyers. It may be advisable for a banker to be present during sale of such land where an NPA is being addressed by disposing the property pledged. But in case of other assets, used for diversion, as receivables or debtors, legal action or threatening of legal action works. Showing a gun rather than shooting works very well. When debtors are projected as bad or doubtful and need to be written off, it is very possible that in reality they could have paid in cash or kind already. The best course of action is to threaten to commence legal proceedings against such non paying parties and to take steps to attach their personal assets. In majority of such accommodating parties, even the very threat of such action brings instant results and full disclosure is made.
7. Creation of **artificial losses** using pretext of recession, disaster events, etc. Very often disaster situations such as fire, flood or some disaster is created to camouflage their devious actions. Stocks are claimed to have been lost far in excess of what are lost in most fire claims. Even the quality of stocks lost is manipulated by claiming that the best quality of stock was lost whereas in reality only rejection, waste and rags may have been lost. All disaster situations could be used for fund diversion, or conversely created to facilitate and camouflage fund diversion. In all disaster situations, the police and fire-brigade reports, surveyor reports, and general inquiries from staff and third parties are absolutely essential and in most cases reveal a wealth of information

The list of such ways and means of fund diversion are endless. What is important for investigators is to inquire further and not accept a situation as non solvable. Our current banking approach across many banks surrender very easily by investigating upto a point and then giving up on account of difficulties faced and costs of further investigations. While this is true, if this attitude continues, borrowers will steal more from banks than dacoits and robbers who will also turn into borrowers for a larger loot.