

# BANKING CONFERENCE

## FRAUD, PRECAUTIONS TO BE TAKEN BY AUDITORS

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CA AMIT MEHER - BDO INDIA



March 19, 2023

The background features a gradient from red at the top to blue at the bottom. On the left side, there are several circular gauges or dials with numerical scales ranging from 140 to 260. A prominent red vertical bar is located on the far left. The right side of the image is dominated by a large, light-colored circular area that contains the main text.

**SECTION**

**1**

**The Expectation**



***Intentional misstatements when it results from:***

- ❖ Fraudulent financial reporting (e.g. inflation of revenue, fictitious JE)
- ❖ Misappropriation of assets (e.g. embezzlement of receipts, payment to fictitious employee)

## WHAT IS FRAUD? RBI

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As per RBI Guidelines “A deliberate act of omission or commission by any person, carried out in the course of a banking transaction or in the books of accounts maintained manually or under computer system in banks, resulting into wrongful gain to any person for a temporary period or otherwise, with or without any monetary loss to the bank”

Auditor should identify fraud which is carried out “with or without any monetary loss to the bank” as well as “resulting into wrongful gain to any person”

# BASIC RESPONSIBILITIES OF MANAGEMENT VS AUDITORS

## MANAGEMENT RESPONSIBILITY

The primary responsibility for the prevention and detection of fraud

Creating a culture of honesty and ethical behavior

## RESPONSIBILITIES OF THE AUDITOR

Obtain reasonable assurance that the financial statements are free from material misstatement due to fraud or error

Maintain professional skepticism throughout the audit

Obtain adequate audit evidence for the risk identified

Respond & Report appropriately on the identified or suspected fraud

# PROFESSIONAL SKEPTICISM - MEANING

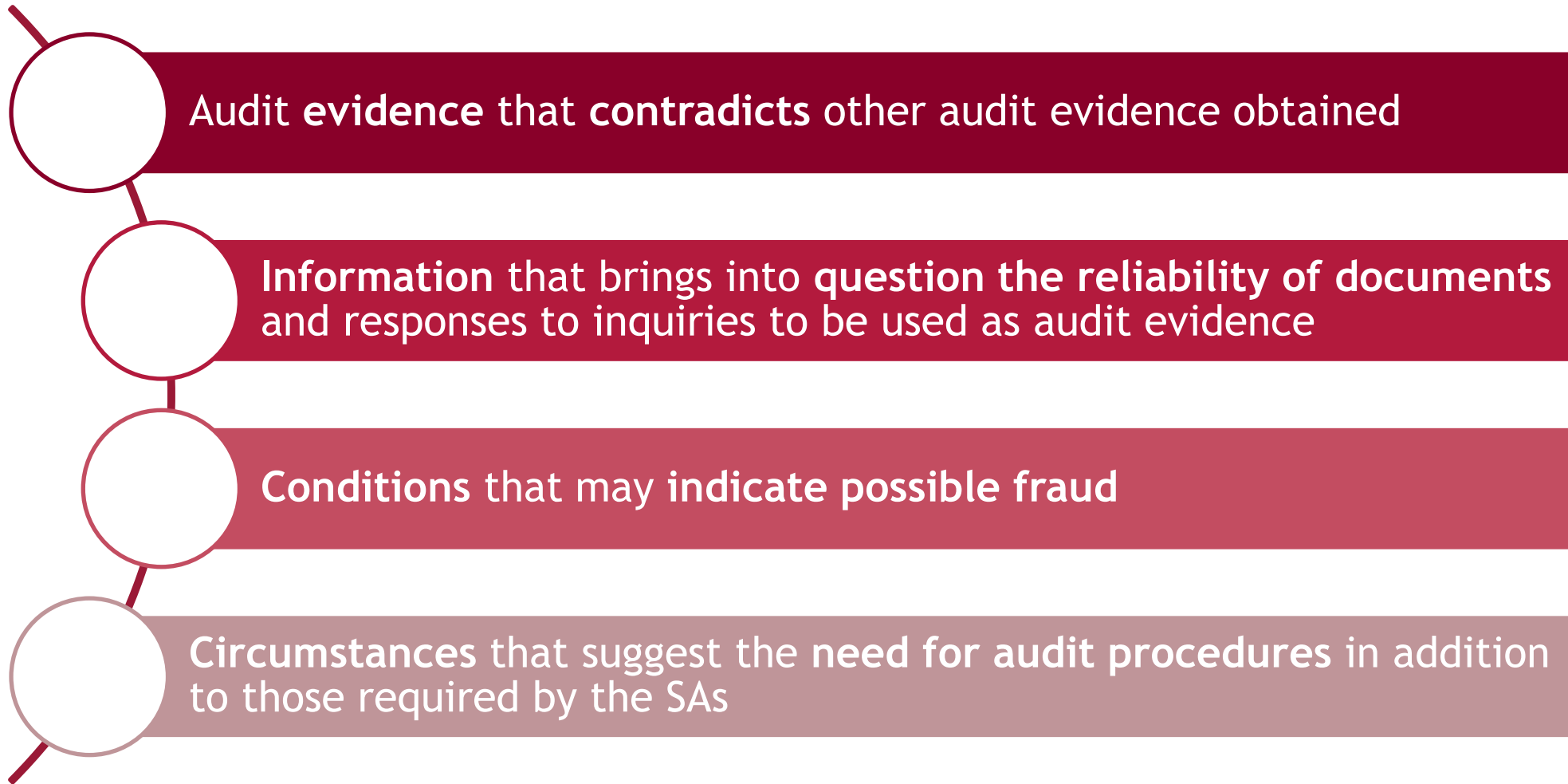
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An attitude that includes a **questioning mind**, **being alert** to conditions which may indicate possible misstatement due to error or fraud, and a **critical assessment of audit evidence**.

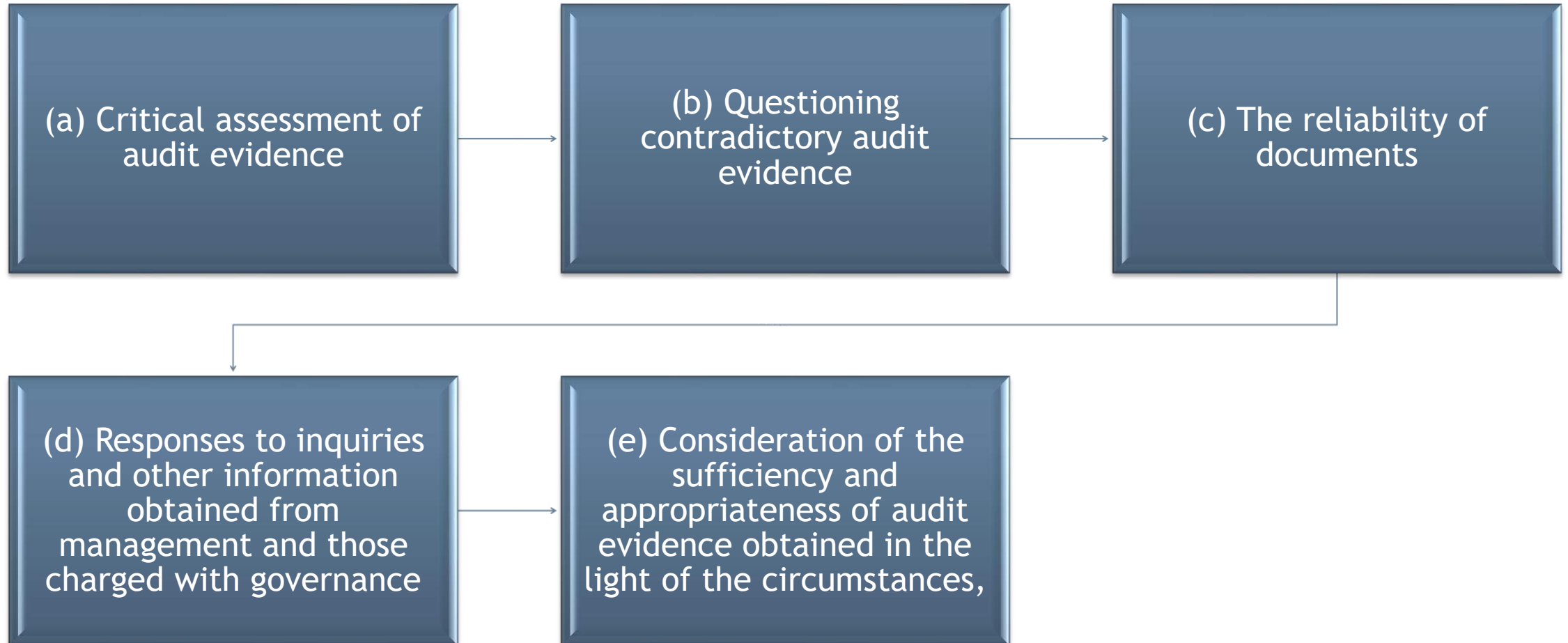


The auditor shall plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

# PROFESSIONAL SKEPTICISM - MEANING

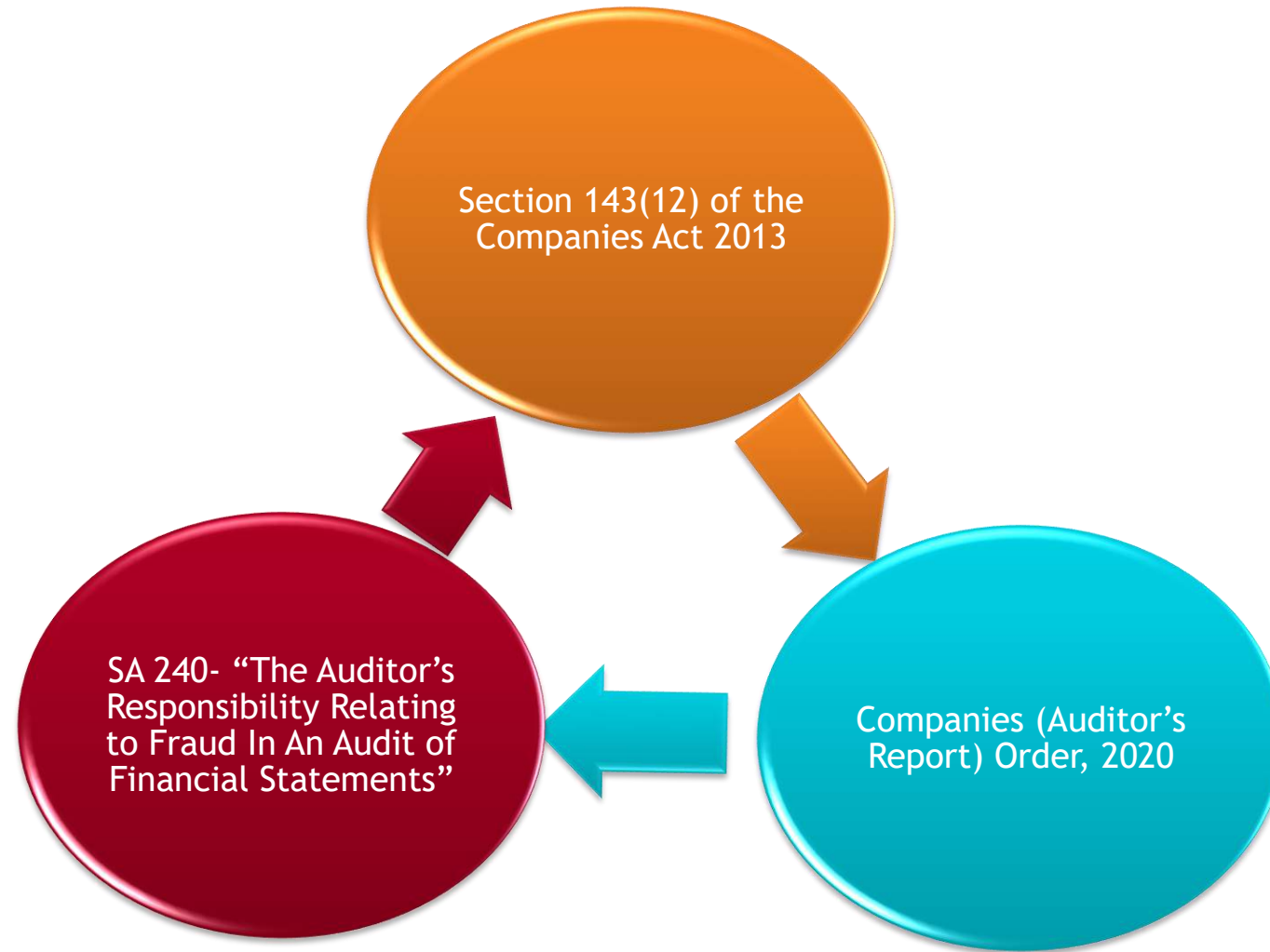


# PROFESSIONAL SKEPTICISM - WORKFLOW





# WHERE DOES THE REQUIREMENT TO REPORT COME FROM?



# WHEN SHOULD YOU AS AN AUDITOR REPORT FRAUD?

Identified during the course of Audit.

Have reason to believe (convincing evidence to advance beyond suspicion ) and have knowledge that a fraud has occurred or is occurring

Against the company by its officers or employees (and does not include fraud by third parties such as vendors and customers, persons who are engaged on a contract basis)

The auditor shall report the matter to the Central Government if it involves or is expected to involve individually an amount of Rs.1 Crore or above.

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**SECTION**

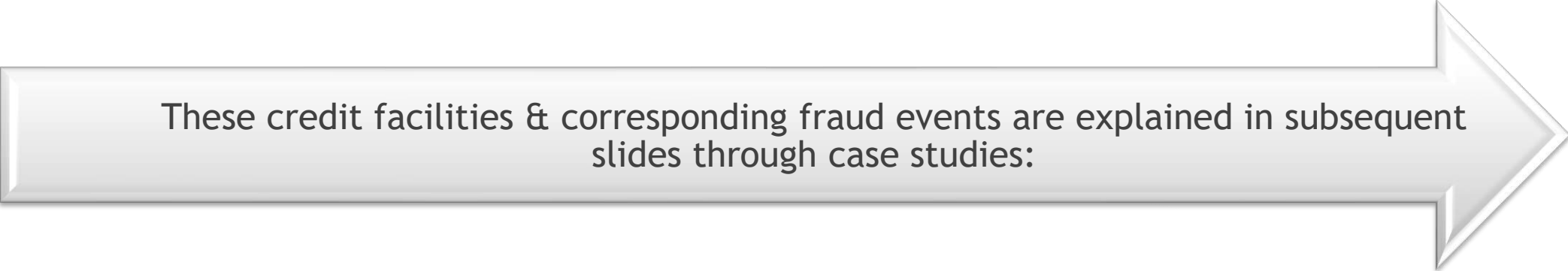
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**CASE STUDIES**

# LOAN FRAUD SCENARIOS

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Forensic audit of NPA accounts has revealed various methods adopted by borrowers to defraud the lenders and divert / siphon off borrowed money which results into loans becoming NPA. Borrower avails credit facilities from banks by way of Working Capital facilities, Term Loans / Project Finance, Standby Letter of Credit / Export bills discounting etc.



These credit facilities & corresponding fraud events are explained in subsequent slides through case studies:

# LOAN FRAUD SCENARIOS - WORKING CAPITAL FACILITIES

## Case Study: Pipe manufacturing company with CC exposure of INR 600 crore (approx.)

- High volume of fictitious trading transactions by manufacturing company
- LC payments made to Vendors & no recovery from customers
- Cash credit facility was availed with higher DP limits through overvaluation of inventory
- Vendor advances shown as receivables in DP
- Consumption of inventory was booked as CWIP - Research & Development

## Precaution to be taken in case of such red flags;

- ✓ Assess nexus between vendor, customer and borrower company
- ✓ Periodic comparison of receivables, payables and inventory balances / aging considered in drawing power computation
- ✓ Check if Vendor advances are considered as debtors for DP computation
- ✓ Verify genuineness of supporting documents for trade transaction submitted to bank for availing credit facilities like LC / Bill discounting
- ✓ Verify Due diligence report of select vendors & customers considered in drawing power computation

## Case Study: Rice manufacturing company with Term Loan & CC exposure of INR 3500 crore (approx.)

- Building (Godowns) construction cost inflated through fictitious cement, wires & electrical procurements
- Crop loans availed in farmer's name with fake KYC & tripartite agreement while loan proceeds shown as farmer advances were siphoned off by borrower company
- Related party loans / Investments to finance capital requirements of other group entity's business
- Inventory overvaluation
- Sales to related party & non recovery of receivables

## Precaution to be taken in case of such red flags;

- ✓ Verify Due diligence report of project vendors
- ✓ Review on sampling basis of project cost invoices and supporting documents submitted at the time of term loan disbursements
- ✓ Review of LIE reports to verify project work status vis a vis project cost incurred
- ✓ Review of periodical DP statements as explained in previous slide

# LOAN FRAUD SCENARIOS - STANDBY LETTER OF CREDIT / EXPORT BILL DISCOUNTING

Case Study: Company engaged in Merchant Trading transactions with exposure of INR 3000 crore (approx.)

- Merchant trading transactions with foreign parties without endorsement of bill of lading
- Payments made for import leg (vendor) while credit period offered to customers (export leg) resulting into outstanding balance of receivables
- Funds routed through fictitious merchant trading transactions and invested in other group business / foreign currency derivative contracts

## Precaution to be taken in case of such red flags;

- ✓ Verify Due diligence report including credit assessment on borrower and foreign vendors / customers
- ✓ Assess nexus between borrower and Buyers / vendors
- ✓ Review of supporting documentation submitted for import & export leg of transactions
- ✓ Review documents for endorsement of bill of lading in case import / export transaction leg in merchant trading on sampling basis

# LOAN FRAUD SCENARIOS - FAKE ACCOUNT OPENING AND CHEQUE DISCOUNTING

## Case Study: Loan & Cheque discounting fraud with exposure of INR 1000 Cr (approx.)

- Multiple saving and current accounts were opened by fraudsters (CA in collusion with bank employees) using KYC documents of common public
- Cheque discounting facility was availed into these accounts by depositing fake cheques of a government entity
- Loans were availed against fake Letter of Credit / security of fake LIC policies
- Funds were invested into real estate properties & business and further loans were availed basis these assets

## Precaution to be taken in case of such red flags;

- ✓ Verify effectiveness of internal control to check KYC documents of account holder while opening new account
- ✓ Verify cheque discounting trends in same bank account / with same account holder
- ✓ Review effectiveness of controls to identify genuineness of security documents offered by customers



# LOAN FRAUD SCENARIOS - TRANSACTIONS WITHOUT CUSTOMER'S AUTHORISATION

## Case Study: Diversion of funds in customer accounts INR 20 Cr (approx.)

- Payment & receipt transaction executed by branch officer without customer's authorisation
- Cash withdrawn from customer account through usage of customer cheque book by branch officer
- Modified bank account statements shared with customers by accused
- Premature redemption of FD by accused & proceeds transferred fraudulently to other account
- Proceeds of customer accounts used for creation of LIC policies in the name of accused & family members
- Misuse of employee access by accused for processing of unauthorised transactions

## Precaution to be taken in case of such red flags;

- ✓ Verify non-operative accounts where there is major activity
- ✓ Verify system controls to ensure FD maturity proceeds being transferred only to FD holders
- ✓ Review of internal control over updation of mobile numbers in customer accounts
- ✓ Verify system controls to restrict misuse of employee access



SECTION

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PRECAUTIONS

# CONDITIONS / EVENT THAT INCREASE RISK OF FRAUD

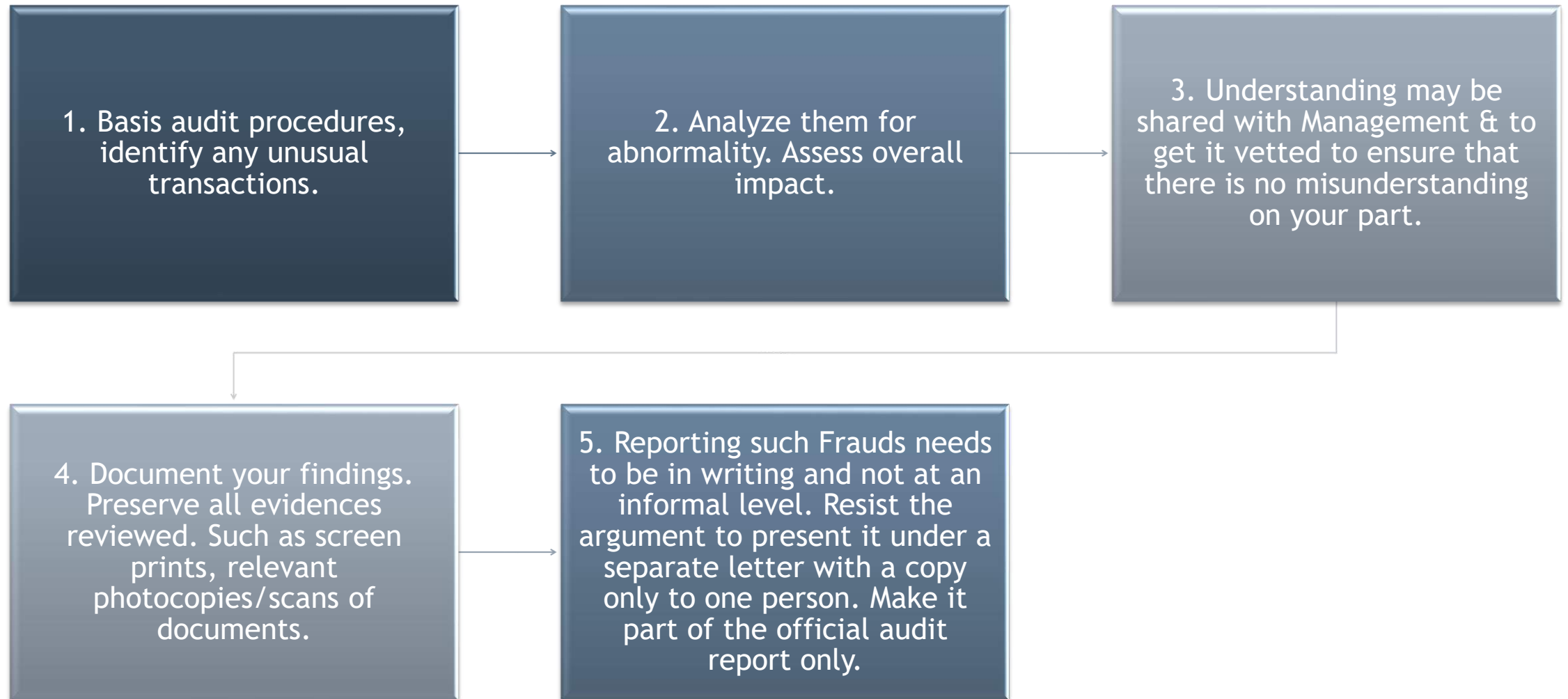
## Fraud Risk Factors - Event or condition that indicate;

- Incentive or pressure to commit fraud,
- A perceived opportunity to commit fraud

Primarily **gaps** in the functioning of accounting and **internal control systems** or **inconsistencies** of internal controls increase risk of Fraud. Further, it can include:

- ***Questionable integrity or competence of management*** like no effective control of shareholders over management, internal control failure, frequent changes in key personnel (CFO, auditor, lawyer etc.)
- ***The existence of unusual pressure in the company or on its management*** like decrease in profits, decrease in revenue, pressure of performance from stakeholders, working capital deficiency
- ***The existence of unusual transactions*** like transactions with material impact during financial year closure, unusually high payment for certain services such as consultant, agents
- ***Difficulties in obtaining sufficient and appropriate audit evidence***
- ***Factors specific to computerised information systems that refer to events and conditions described above***

# APPROACH FOR FRAUD DETECTION & REPORTING



# BROADER AUDIT APPROACH & PROCEDURES

Assess effectiveness credit appraisal & monitoring mechanism for advances

Ask for Early Warning Signals (EWS) report for red flagged activities in respect of loans

Review of credit rating reports to monitor changes for key advances / customers

Review Internal Audit, Inspection report. Review of ASM reports in respect of advances above INR 250 Crore

Review history and trends of fraud detected. Review of any Investigation / *Special audit reports*.

Review and analyze modus operandi of major frauds reported during the year along with their present position

Assess whether frauds are examined from staff angle and, wherever necessary, the cases are reported to the Vigilance Cell for further action

Heightened professional skepticism where there are Manual controls, absence of Segregation of duties, concentrated decision making, absence standard processes and weak system controls.

Adequate referencing / disclosure in KAM

## ➤ Detecting red flags in Advances -

Checks for Deficient appraisal system & inadequate post disbursement monitoring;

- Pre-sanction -
  - Assessment of background & track record,
  - legal disputes,
  - Statutory non compliances
  - validation of data submitted,
  - checking of defaulter list
- Disbursement - Compliance with sanction requirement
- Monitoring /Account Operations -
  - End use monitoring,
  - Pressure/insolvency in group
  - Analysis of Financial Statements. Unusual year on year variances in financial statement
  - Variance stock audit report vs. stock statement

## ➤ Detecting red flags in Advances -

- Monitoring /Account Operations - (continued...)

- Bouncing of high value cheques
- Delay observed in payment of outstanding dues (vendor due, statutory dues, etc.)
- Frequent Request for General Purpose Loan
- Funding of Interest by Sanctioning additional facilities
- High level of unbilled revenue
- Non submission of stock audit report / Drawing Power statement / Financial Statements
- Basis for upgrade of NPA account. Assess possibility of Evergreening of loans / Window dressing to avoid loan account classification as NPA
- Monitoring of borderline cases which are nearing NPA.
- Monitoring of 'continuously' overdrawn account
- Monitoring of overdue Bills Purchased and Bills discounted

## ➤ **Frauds involving of bank staff-**

Following are the possible scenarios where bank staff is involved in fraud;

- Not debiting applicable charges, penal interest
- Mis-classification of products offered for manipulating interest/charges
- Concession in charges on LCs / BGs
- Opening account under new customer code for potential NPA cases
- Account opening with fake signatures / KYC documents
- Wrong rating, not updating rating
- Wrong Moratorium
- Delay in registering charge
- Unauthorized fund transfer from dormant accounts





Q & A

# BANKING CONFERENCE

## FORENSIC & ASM - OPPORTUNITIES & WAY FORWARD

CA AMIT MEHER - BDO INDIA



March 19, 2023



## THE REQUIREMENT FOR FORENSIC AUDITS BY BANKS

Due to rising trends in loan related frauds and delay in detection and reporting of such frauds by banks, the Reserve Bank of India (RBI) in its circular of 07 May 2015 issued a **Framework for dealing with loan frauds**.

The circular specifies that the loan account based on Early Warning Signals would be classified as Red Flagged Account and subjected to a forensic audit commissioned or initiated by the consortium leader or largest lender. After the forensic audit the consortium would decide on the status of the account. In case the decision is to classify the account as a fraud, the RFA status would change to Fraud in all banks and reported to RBI and the lead bank shall file a complaint with CBI.

## KEY OBJECTIVES OF FORENSIC AUDITS

- Establish End Use of Funds (misuse, diversion, siphoning and misappropriation)
- Manipulation of books of accounts
- Identify instances of inflation of revenues, unreasonable expenditures and write offs
- Verify assets, inventories and book debts for nonexistent, inflation, reciprocal adjustments, write-off or unusual sale/transfer of assets
- Verification of related party transactions (loans, investments, operational transactions and adjustments)
- Review concentrating transactions sole customer, sole supplier, major transactions with related parties/group companies and identify any bogus/fictitious third parties.
- Comment on transactions of substantial amount, which seem not to be normal trade transactions at arms' length
- Tracing the source and genuineness of contribution by promoters by analyzing equity infused by promoters/partners

# AGENCY FOR SPECIALISED MONITORING (ASM) AND KEY OBJECTIVES

## THE REQUIREMENT FOR ASM

RBI released a report dated December 31, 2018, on Financial Sector: Regulation and Developments. One of the recommendations in the report was to establish **additional surveillance measures to monitor advances above INR 250 crores**. Following the recommendation, the Indian Banks Association (IBA) established a panel of Agencies for Specialised Monitoring. Specialised monitoring is a **preventive measure to regularly review borrower's operations on ongoing basis**. The lead bank on behalf of the consortium shall appoints the ASM.

Appointment of Agencies for specialized monitoring (ASM) was one of the key reforms of the Department of Financial Services for Public Sector Bank, under EASE 3 (Enhanced Access and Service Excellence) Reforms Agenda.

## KEY OBJECTIVES OF ASM

- Cash Flow Monitoring
- End Use of Funds/Siphoning of Funds
- Verify that the group company transactions are at arms length
- Validation of Drawing Power as per Banks' sanctioned terms
- Sales/Purchase Monitoring
- Stock & Receivable review
- Review of project progress vis-a-vis scheduled milestones, capacity utilisation, asset book size, quality and diversification
- Verification of routing of project revenue and expenses through designated bank accounts
- Verification of project expenses, payments to creditors and advances to suppliers
- Review of unbilled revenue and WIP and justifiable reasons for the same
- Assessment of Quarterly Key Financial Indicators
- Any other Key Areas Review (KAR) which the Banks find necessary to be monitored

# CRITERIA FOR EMPANELMENT

## FORENSIC AUDIT

The Indian Banking Association (IBA) empanels forensic auditors under two categories:

- Frauds above INR 50 crores and
- Fraud upto INR 50 crores

The key minimum criteria for empanelment:

- ✓ 5 yrs exposure of the firm in forensic investigation
- ✓ 3 yrs experience of at least one chartered account
- ✓ 3 no. of chartered accountants employed
- ✓ 1 Certified Fraud Examiners/ Qualified in Forensic and Cyber securities
- ✓ 3 yrs experience in concurrent and stock audit in Bank
- ✓ 5 Banks/FIs served as concurrent and statutory auditor
- ✓ Engagement of skilled professionals (legal experts, AML experts, detectives, expert witnesses, etc.)
- ✓ The firm and employees should not be in the defaulters/barred/caution list/ disciplinary action
- ✓ Registered with other professional bodies ICAI, ICWAI, IEI, ECI, etc
- ✓ All India Presence of the Firm
- ✓ Two bank references (applicable for fraud > 50 crores)

## AGENCY FOR SPECIALISED MONITORING

The Indian Banking Association (IBA) empanels agency for specialised monitoring for loan exposures above 250 crores

The key criteria for empanelment is as under:

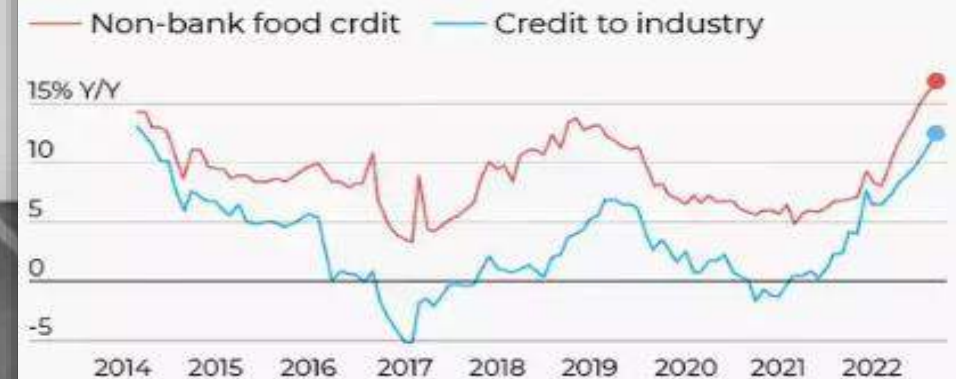
- ✓ Minimum experience of 3 years in statutory audit/concurrent audit/forensic audit/TEV/Cost Audit/Transaction monitoring/Specialised Monitoring
- ✓ Sector Specific Qualifications and work experience
- ✓ Registered with professional bodies ICAI, ICWAI, IEI, ECI, etc
- ✓ Should not be in the defaulters/barred/caution list

## CAPEX REVIVAL LEADS TO INCREASE IN CORPORATE LOANS

- There is a rising trend in corporate lending. As per RBI report published in December 2022 (Financial Institutions: Soundness and Resilience) the share of top 100 large borrowers in the total loan book of banks continued to rise and stood at 17.4 per cent in September 2022, signaling fresh borrowing by large corporates.
- Sectors seeing strong loan demand include infrastructure, real estate, iron and steel, oil sector and automobiles.
- Annual capital spending for India's 15,000 largest industrial companies is projected to be Rs 4.5 lakh crore (\$55 billion) in the financial year to March 2023 and expected to grow in the following years.
- While initial funding will be from internal accruals, borrowings from banks are rising and expected to grow further in the next years.

### India's credit to industry at 8-year high

The early signs of a pick-up in corporate credit demand signal a strong recovery in the Indian economy.



Note: Non-food credit includes that to agriculture and allied activities, industry, services, and personal loans

Source: Reuters

# OTHER OPPORTUNITIES IN THE BANKING SECTOR

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Pre-lending due diligence / Integrity due diligence of borrowers

Asset Tracing

29 A Due Diligence under Debt Resolution by Banks

Bank Guarantee Audits

Investigation of letter of credit facilities including merchant trading and bill discounting

CIRP Expense Audit

Investigation of Internal Frauds at Banks

Anti Money Laundering Reviews and Investigations

Know Your Customer (KYC) Reviews and Due Diligence



Q & A