

AUDITORS RESPONSIBILITY IN BANKING FRAUDS

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INTRODUCTION

- How many Frauds found by Auditors?
- Is Audit an Art?
- Can be very seriously affecting the CA in service or Practice
- Can be a threat to survival of an Enterprise
- Recent Frauds

AUDITING STANDARDS APPLICABLE IN CASE OF FRAUD

- SA – 200 – Overall objectives of Independent Auditor and the Conduct of Audit in Accordance with Standards on Auditing.
- SA – 220 – Quality Control for an Audit of Financial Statements.
- SA – 240 - The Auditor's Responsibilities relating to Fraud in an audit of Financial Statement.

AUDITING STANDARDS APPLICABLE IN CASE OF FRAUD

- SA – 250 - Consideration of Laws & Regulations in an Audit of Financial Statement.
- SA – 260 – Communication with those charged with Governance.
- SA – 265 - Communicating deficiencies in internal control to those charged with Governance & management.

DEFINITION

- SA-240 – The Auditor’s Responsibilities relating to Fraud in an Audit of Financial Statements.

“Fraud is an intentional act to obtain an unjust or illegal advantage.”

DEFINITION

- RBI working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds -

“A Fraud is a deliberate act of omission or commission by any person carried out in the course of a Banking Transactions 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.”

EXPECTATION GAP

➤ Auditor should have found the Fraud

V/S

➤ Auditor could have found the Fraud

OBJECTIVES OF THE AUDITOR

- Identify & Assess the risk of material misstatement
 - Fraudulent Financial reporting
 - Misappropriation of Assets

KINDS OF FRAUDS

➤ Mis-appropriation of Assets –

- Embezzlement of receipts in respect of written-off accounts.
- Stealing physical assets or intellectual properties
- Introduction of fictitious vendors
- Payment of fictitious employees
- Using entities assets for personal use.

KINDS OF FRAUDS

➤ Fraudulent Financial Reporting

- Alteration or falsification of records & documents
- Misrepresentation in or intentional omission of events, transactions or information
- Intentional misapplication of accounting principles

KINDS OF FRAUDS

- Fraudulent Financial Reporting.. Contd.
 - Fictitious Journal Entries
 - Adjusting assumptions and changing Judgments
 - Omitting, advancing or delaying the recognition of events or transactions.

FRAUD V/S ERROR

- Errors are due to –
 - Inefficiency,
 - Incompetency, or
 - Indifference.
- Fraud stem from efficient, skillful, shrewd and calculated planning

DETECTION OF FRAUD

➤ Audit Risk -

- Risk of material mis-statement
- Detection Risk

➤ Inherent Limitations of Audit

DETECTION OF FRAUD

- Possible Audit Procedures
- Communication of Fraud with those charged with Governance
- Withdrawal from Assignment

TYPES OF FRAUDS

- Fraudulent Entries
- Sales Frauds
- Collection Frauds
- Expenses Frauds
- Payroll Frauds
- Data Frauds
- Banking Frauds

FRAUDS IN ADVANCES

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FRAUDS – ADVANCES

- **Advances Portfolio Frauds – Reasons**
 - Deficient appraisal system
 - Poor post disbursement supervision
 - Inadequate follow-up
- **Advances Portfolio Frauds - Methods**
 - Fabricated fudged financial statements
 - Inflated Security Valuation / Defective search Report.

FRAUDS – ADVANCES

➤ Advances Portfolio Frauds

- Delaying in reporting results into delay in alerting other banks about modus operandi,
- delay in action against unscrupulous borrowers
- increase in the losses arising out of frauds.

FRAUDS – ADVANCES

➤ Checks to be carried out during difference stages -

a. Pre-sanction

- a. Track record,
- b. legal dispute,
- c. raids on business,
- d. unfavorable assessment orders,
- e. validation of information submitted
- f. checking from defaulters list of RBI

FRAUDS – ADVANCES

➤ Checks to be carried out during difference stages - Contd..

b. Disbursement - Checks

- Adherence to the terms and conditions of sanction
- Rationale for allowing dilution of these terms and conditions
- Level at which such dilutions were allowed etc.

Broad framework by the Board to specify certain terms and conditions as 'core', which should not be diluted.

FRAUDS – ADVANCES

➤ Advances Portfolio Frauds

c. Annual Review – From Annual accounts

- Diversion of funds in an account
- Adequacy of stock vis-à-vis stock statements
- Stress in group accounts

Track market development by following up stock market movements, subscribing to press clippings, monitoring data base of the group

FRAUDS IN CONNIVANCE WITH BANK STAFF

- Commitment charges not debited
- No penal interest applied
- Concession in charges on LCs / BGs
- Change of renewal period/date
- Opening account under new customer code (TDS, NPA)

FRAUDS IN CONNIVANCE WITH BANK STAFF

- Mis-Classification of guarantees to financial instead of performance for manipulating charges
- Stock statement frequency wrongly entered
- Negative comments avoided in Inspection Reports
- Lesser margin entered/changed for DP

FRAUDS IN CONNIVANCE WITH BANK STAFF

- DP is entered as Sanctioned Limit
- Field for interest manipulated
- Rating wrongly entered /not updated /not obtained /not renewed
- Moratorium wrongly entered

OPERATION OF ACCOUNT

1. Bouncing of high value cheques

- Bank not to allow withdrawal against effect
- Used to avoid NPA

OPERATION OF ACCOUNT

2. Delay observed in payment of outstanding dues

- **A. Result**
 - Creditors – Goods purchased at unfavourable rate, loss of early payment discount, Non availability of timely raw material hampering production

OPERATION OF ACCOUNT

2. Delay observed in payment of outstanding dues

➤ A. Result ..Contd.

- Statutory dues – Prosecution, Criminal action, Seizure of assets, Attachment of Bank Account
- Essential services – Water, Electricity – Stoppage of production
- Rent – Eviction

OPERATION OF ACCOUNT

2. Delay observed in payment of outstanding dues

➤ B. Liquidity Crises Due to -

- Losses
- Unwise Financial Management (Investment in non saleable goods, Short-Term funds used for Long Term investment)

OPERATION OF ACCOUNT

2. Delay observed in payment of outstanding dues

➤ B. Liquidity Crises Due to – Contd..

- Key debtors as Government Concerns
- Inability to dispose off non-core assets
- Diversion of funds for – purchase of personal assets, investment in share market

OPERATION OF ACCOUNT

3. Frequent Request for General Purpose Loans

- Ever greening (New Loans taken to repay old loans)
- In accurate assessment of working capital requirements
- Inability of borrower to raise funds from internal sources
- Diversion to non-business investment

OPERATION OF ACCOUNT

4. Funding of Interest by Sanctioning additional facilities

- Wrong appraisal
- Unviable Project
- Diversion of funds given for building capital asset cost overruns

OPERATION OF ACCOUNT

5. Frequent Adhoc Sanctions

a. Adhoc limits are required for –

- Sudden bulk orders requiring additional working capital
- Disbursal pending proposal for approval of working capital enhancement
- Sanction for any contingency needs.

OPERATION OF ACCOUNT

5. Frequent Adhoc Sanctions

b. Risk Involved in adhoc sanctions are –

- Diversion of funds
- Cost escalation financed
- Inadequate security cover
- Regularization of adhoc limit by sanctioning additional limit

OPERATION OF ACCOUNT

5. Frequent Adhoc Sanctions

c. Auditor to see –

- Regularization within 3 months
- Approval of higher authorities for such sanctions
- Specific information on performance of the borrower
- Covering adhoc sanction in securities
- Documentation and end use of funds.

CONCEALMENT AND FALSIFICATION OF DOCUMENTS

- Concealment of certain vital documents like Master Agreement, Side Agreement etc.
- Material discrepancies in the annual report
- Significant inconsistencies within the annual report (between various sections)
 -

CONCEALMENT AND FALSIFICATION OF DOCUMENTS

- **Material discrepancies / inconsistencies in/within annual report – Bank to check**
 - Difference in key figures reported in stock statements/QIS/CMA data with Annual Report
 - Accounting policies in variance with Accounting Standards
 - Missing Disclosures
 - Non Provision against long outstanding debtors
 - Significant related party transaction

CONCEALMENT AND FALSIFICATION OF DOCUMENTS

➤ **Material discrepancies / inconsistencies in/within annual report – Bank to check..contd..**

- Short term funds used for long term investment
- Increase in loans/investments/guarantees to related parties
- Adjustment of losses directly to reserve
- Incorrect amortization of intangible assets
- Non Provision of impairment
- Creation of deferred asset without virtual certainty
- Carry forward of expenses.

CONCEALMENT AND FALSIFICATION OF DOCUMENTS

➤ **Material discrepancies / inconsistencies in/within annual report – Bank to check..contd..**

Areas of Financial Statement Frauds –

- Fictitious revenue
- Timing Difference in recognising revenue in long term contracts and channel stuffing
- Concealment of liabilities and expenses
- Capitalisation of Expenses
- Warranties

CONCEALMENT AND FALSIFICATION OF DOCUMENTS

- **How to detect financial statement Frauds-**
 - **Financial Statement Analysis -**
 - ✓ Verticle – Analyzing relationship between the items on Income Statement, Balance sheet and Cash Flow Statement by expressing components as percentages
 - ✓ Horizontal – Percentage change from year to year
 - ✓ Ratio Analysis

CONCEALMENT AND FALSIFICATION OF DOCUMENTS

- **Frequent changes in accounting period and/or accounting policies (life of assets)**
 - Create short period to avoid loss booking.
 - Frequent changes in accounting judgments and accounting estimates without apparent reasons.

CONCEALMENT AND FALSIFICATION OF DOCUMENTS

- **Frequent changes in accounting period and/or accounting policies (life of assets)**

Bank Response –

- Deployment of sufficient staff with adequate Industry specific knowledge.
- Listing Industry practices on judgements and estimates.

CONCEALMENT AND FALSIFICATION OF DOCUMENTS

- Claims not acknowledge as debt high
- Substantial increase in unbilled revenue year after year.
 - Unbilled revenue is revenue which has been recognized but has not been billed to the purchaser.

CONCEALMENT AND FALSIFICATION OF DOCUMENTS

- The most common reason for unbilled revenue are -
 - Timing difference
 - Rate variances
 - Use of percentage completion method
- Risks to Bank –
 - Increase borrowings resulting from increased turnover.(IT Sector & Real Estate Business)

CONCEALMENT AND FALSIFICATION OF DOCUMENTSs

- **The risk of fraud can be sensed from following indications –**
 - Constant rise in unbilled revenues year after year with no new contracts or arrangements
 - Unbilled receivables growing faster than sales
 - Inability to generate cash flows from operations while reporting earnings and earnings growth.

CONCEALMENT AND FALSIFICATION OF DOCUMENTS

- **The risk of fraud can be sensed from following indications – Contd...**
 - Substantial increase in related party transactions which are unaudited.
 - Frequent change in Revenue Recognition policy
 - Long old outstanding unbilled revenue

CONCEALMENT AND FALSIFICATION OF DOCUMENTS

- **Unbilled Revenue – Bank Response**
 - Get contract details
 - Understand Revenue Recognition Policy
 - Aging of unbilled Revenue to be scrutinized
 - Get audit of receivable done periodically

DIVERSION OF FUNDS

- Not routing of sales proceeds through consortium member bank / lenders to the company and also stock depletion not informed
- High value RTGS payments to unrelated parties
- Increase in borrowings, despite huge cash and cash equivalents in the borrower's balance sheet.

ISSUES IN PRIMARY/ COLLATERAL SECURITY

- Dispute on title of collateral securities.
- Postponing the inspection of the godown for flimsy reasons.
- Critical issues highlighted in the stock audit report

ISSUES IN PRIMARY/ COLLATERAL SECURITY

- Significant movements in inventory/receivables, disproportionately differing vis-à-vis change in the turnover.
- Costing of the project which is in wide variance with standard cost of installation of the project.

INTER-GROUP / CONCENTRATION OF TRANSACTIONS

- Funds coming from other banks to liquidate of outstanding loan amount unless in normal course.
- Large number of transactions with inter-connected companies and large outstanding from such companies.

REGULATORY CONCERNS

- Default in undisputed payment to the statutory bodies
- Raid by Income tax/sales tax/central excise duty officials

OTHERS

- Resignation of the key personnel and frequent changes in the management.
- Significant reduction in the stake of promoter/director or increase in the encumbered shares of promoter/director.

SUMMARY

- No one signal can be seen in Isolation. In case of Fraud, several signals would appear together.
- Banks should build processes and controls for prevention and timely detection of frauds.

SUMMARY ... Contd

- Controls can be internal or external, manual or information technology based.
- Timely scrutiny of Data received, by those having appropriate knowledge can only be effective check on frauds.

FRAUD IN SPECIFIC ADVANCES ACCOUNTS

- i. LOU / LOC
- ii. Car
- iii. Xerox Machine
- iv. Loan against FDs
- v. Fake NSCs

FRAUD IN SPECIFIC ADVANCES ACCOUNTS

vi. Stocks

- Inflated stock statements
- Stock of sister concern shown as own stock,
- Common stock shown to various bankers,

FRAUD IN SPECIFIC ADVANCES ACCOUNTS

vi. Stocks..Contd..

- Level of creditors higher than as reported to bank
- Stocks identified as non-moving, or slow moving or non saleable included in statement to bank
- Stock valuation not done properly

FRAUD IN SPECIFIC ADVANCES ACCOUNTS

vi. Stocks..Contd..

- Suppliers name on the bills and on the stock packing do not tally,
- Un saleable stock put into pledged godown
- Billing to sister concerns not supported by stock movement

FRAUD IN SPECIFIC ADVANCES ACCOUNTS

vii. Debtors

- Ageing of debtors indicating loans outstanding debit balances or irrecoverable balances
- Debit balances of creditors shown as debtors

FRAUD IN SPECIFIC ADVANCES ACCOUNTS

vii. Debtors... contd..

- Debtors requested to pay directly to the creditors,
- Written-off debtors reported as good,
- Advance receipt not deducted from debtors list

FRAUD IN SPECIFIC ADVANCES ACCOUNTS

viii. Bills

Accommodation Bills

ix. L/C and Bank Guarantees

L/Cs issued after devolvement of first LC

FRAUD IN SPECIFIC ADVANCES ACCOUNTS

x. Security Documents

- Forged/duplicate land documents
- Valuation of property inflated

xi. Falsification of Information

Inflated projections



THANK YOU