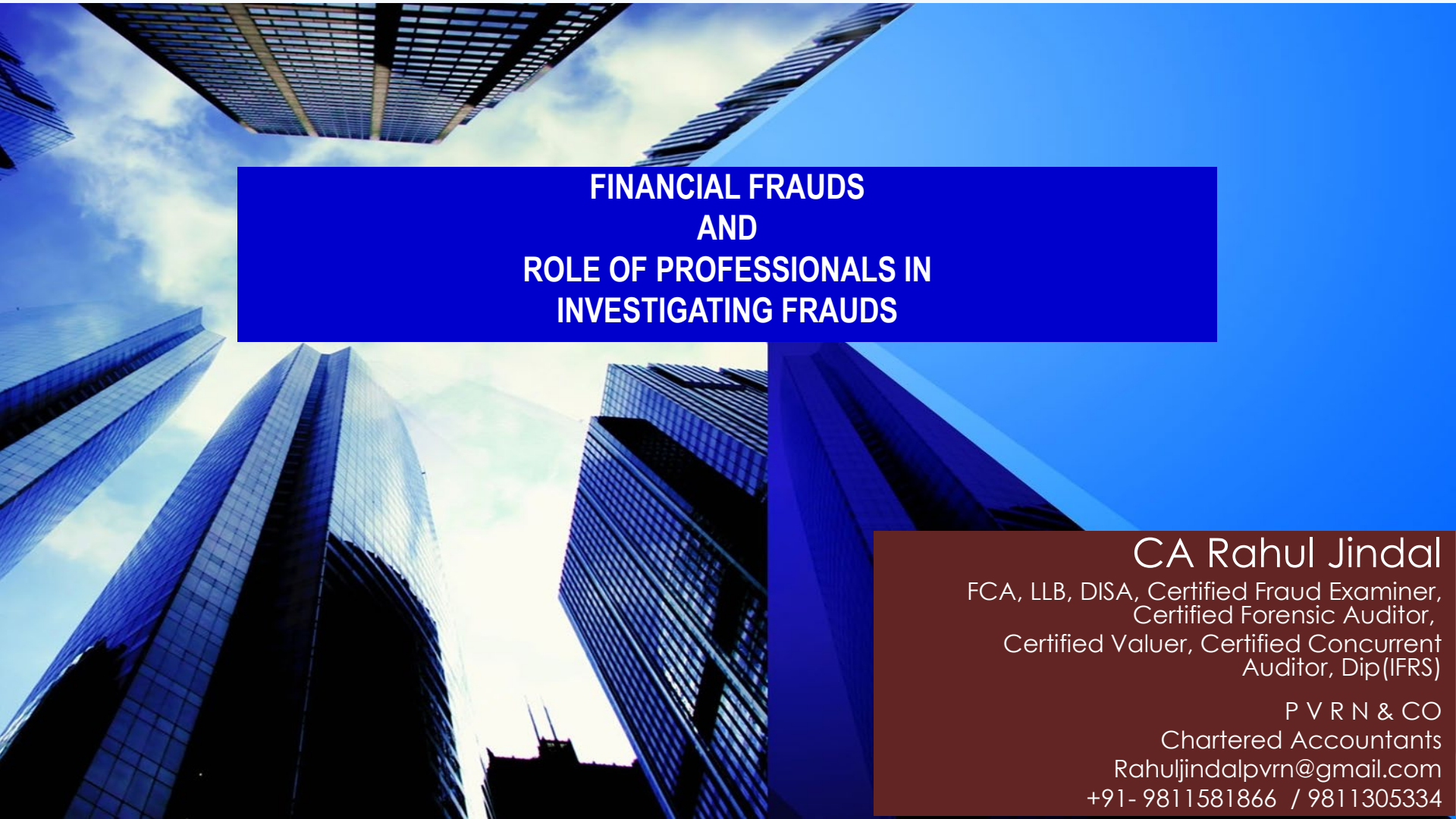

FINANCIAL FRAUDS AND ROLE OF PROFESSIONALS IN INVESTIGATING FRAUDS

CA Rahul Jindal

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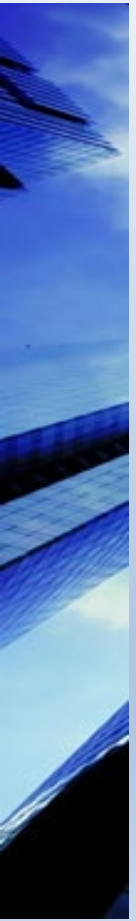

About CA Rahul Jindal

- Rahul Jindal is a qualified FCA, LLB, DISA, Certified Fraud Examiner, Certified Forensic Auditor, IBBI Registered Valuer, Certified Concurrent Auditor, Diploma (IFRS).
- Rahul Jindal is a Forensic Audit Expert and has handled more than Rs 35,000 crore of Forensic Audits for Public Sector Banks, Private Sector Banks, BSE and Other Financial Institutions.
- He has taken seminars for various institutions such as NIRC-ICAI, BANK OF INDIA, ECONOMIC OFFENSE WING, NIRC-Study circles, WIRC Study Circles.
- He can be contacted anytime at rahuljindalpvrn@gmail.com / 9811581866 / 9811305334.

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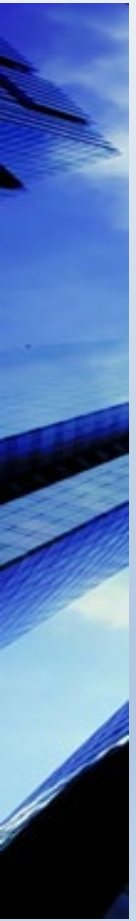

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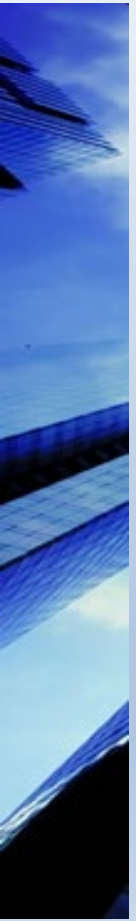
Content

1. FRAUD OVERVIEW
2. FORENSICS OVERVIEW
3. NATURE OF FINANCIAL FRAUDS
4. INVESTIGATION PROCESS
5. FRAUD PREVENTION
6. CONCLUSION

1. FRAUD OVERVIEW

- Definition
- Fraud Perpetrators
- Types of Frauds
- Key Ingredients
  - Fraud Triangle

Fraud Definition - Classical

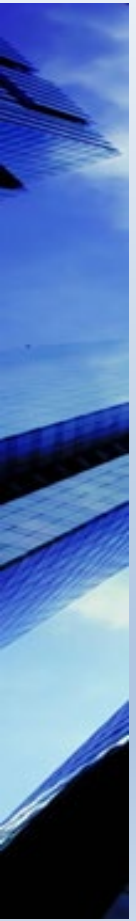


"Fraud is the unlawful and intentional making of a misrepresentation with the intent to deceive and to defraud by causing actual and potential prejudice"

"Wrongful or criminal deception intended to result in financial or personal gain"

"Unfair advantage by unlawful or unfair means"

Fraud Definition – As per CA, 2013



Definition of fraud as per Section 447 (1) Companies Act 2013

(i) "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.

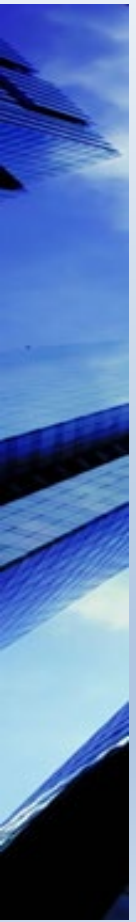
(ii) "wrongful gain" means the gain by unlawful means of property to which the person gaining is not legally entitled;

(iii) "wrongful loss" means the loss by unlawful means of property to which the person losing is legally entitled.

Fraud Definition – Key Essence

- Fraud is different from unintentional error.
  - For example if someone mistakenly enters incorrect numbers on a financial statement it does not constitute fraud.
- This is because there was no intent and the purpose was not to gain advantage over another through false pretense.
- The corollary of that is that if there had been intent to deceive investors then it would be fraud.
- Proving intent is the key.

Fraud Perpetrators – Company



- Prohibited business activities
  - such as, those that violate government statutes, rules, regulations, or contracts
- Intentional improper representation or valuation of transactions, assets, liabilities or income
- Intentional improper transfer pricing. Thus, improving the operating results of an organization involved in the transaction detriment of the organization.
- Intentional improper related party transactions in which one party receives some benefit not obtainable in an arm's length transaction.
- Intentional failure to record or disclose significant information to improve the financial picture of the organization to outside parties.
- Tax Frauds

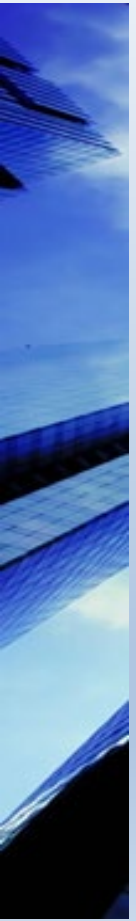
Key Ingredients of Fraud – The Triangle

Why People Commit Fraud

Famed criminologist Donald R. Cressey

Even the best systems of internal control cannot provide absolute safeguards against irregular activities.

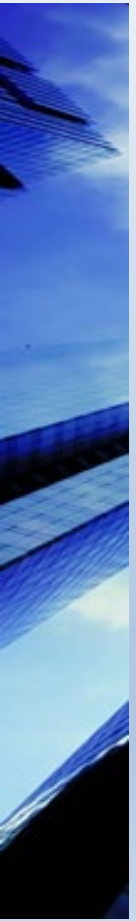
Fraud Motives – Need or Greed



The main motive is to get some personal gain/benefit:

- Poor personal financial situation is also a key trigger
  - Debts/loans from family education/wedding etc
- Desires of enjoying life and a passion for fun also pushes one in this direction
  - Big house/fancy cars/vacations
- Undue pressure from superiors/management makes some to take unethical short cuts
  - Tight deadlines/difficult sales targets
- Vindictive nature of aggrieved employees

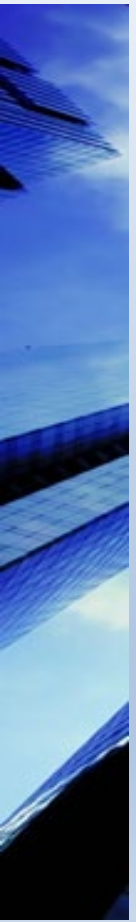
Opportunity for Fraud



Many circumstances provide the opportunity to the fraudsters:

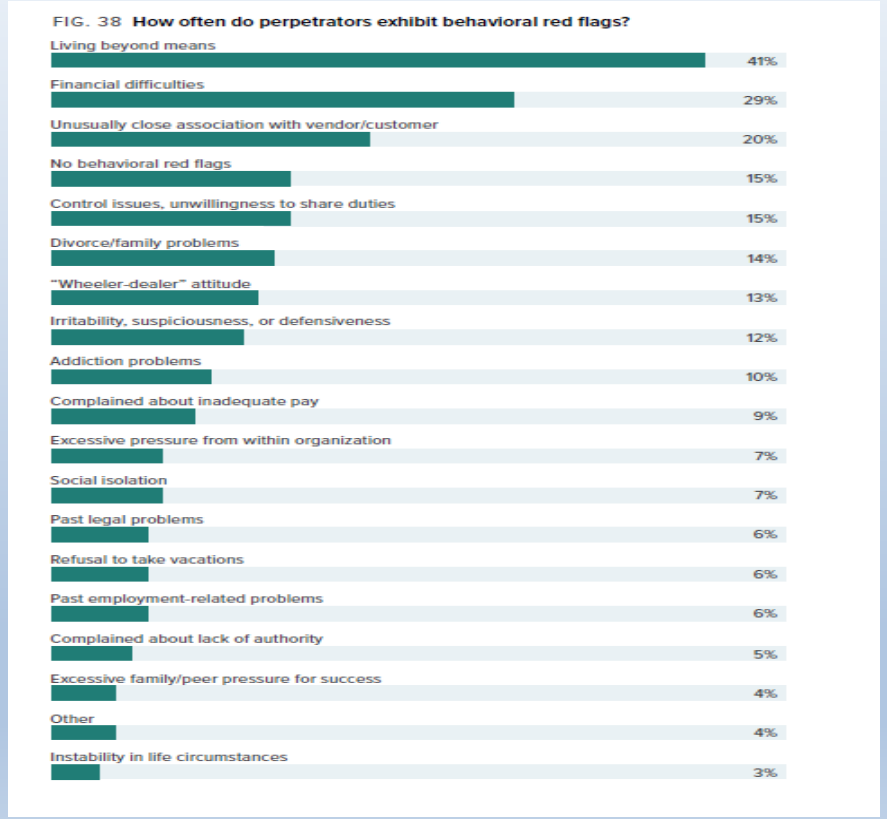
- Lack of or Weak Internal Controls:
  - These allow the irregulates to occur and not be detected in time
- Poor awareness of policies and procedures provide excuse:
  - Lack of documented P&P creates confusion and opportunity (plead ignorance)
- Undue dependence on IT Systems:
  - Lack of audit trail
- Too much trust and reliance on some people:
  - Too much access/authority which is then misused
- Too little monitoring and review :
  - Inadequate action

Rationalisation – Self justification



- It's OK to do this:
  - Everybody is doing it, why not me?
- I can get away with it as nobody will notice me!
  - chances of getting caught are too slim.
- The benefits or rewards far exceed the consequences!
  - At most I will need to return part of the loot.
- No body has ever been taken to the police!
  - Will seek forgiveness.
- They have mistreated me, I need revenge!
  - My chance of getting even.
- They will be impressed by my sharp mind and smartness (hacker)!

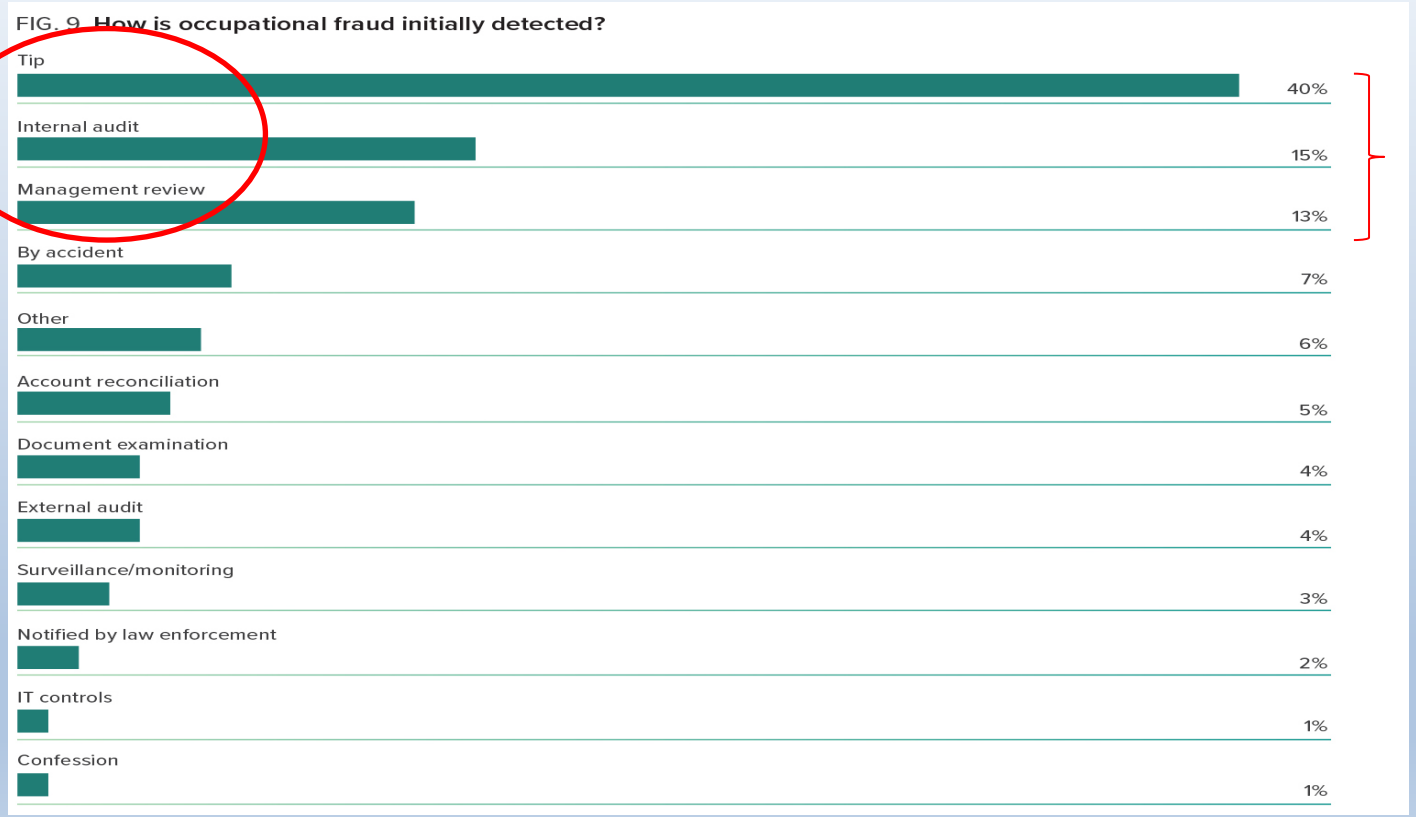
Fraud Alerts – Red Flags



Source: ACFE 2018 Report to the Nation

- The top three alerts which can indicate a high probability of fraud being perpetrated are the following:
  1. Living beyond means
  2. Financial difficulties
  3. Close association with vendors/customers
- As per the fraud triangle, the first two flags point towards a motivation, while the third indicates an opportunity!

Fraud Detection Methods



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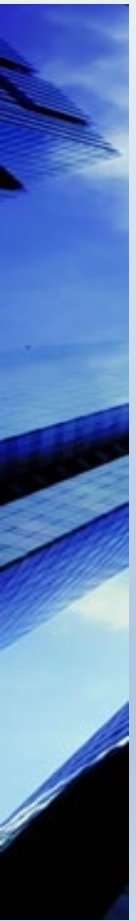
Source: ACFE 2018 Report to the Nation

2. FORENSIC OVERVIEW

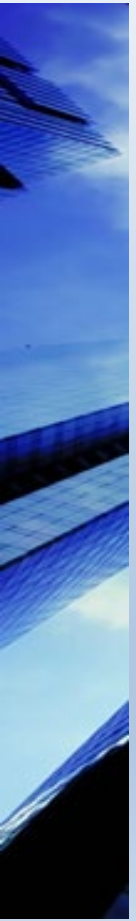
- Definition
- Comparison with Audit
- Specialised Forensic Techniques

Audit Vs. Forensics…1 of 3



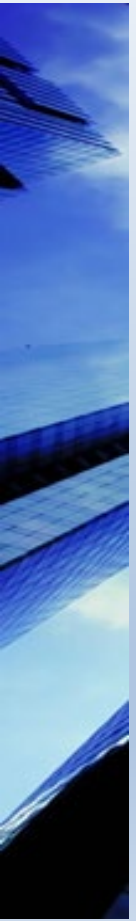
- A forensic audit is very different to a typical financial audit.
  - A financial audit is usually a sampling activity that does not review every transaction.
- As a consequence, the system can be abused and exploited by an insider
  - someone who appreciates the finer points of the system and is able to bypass controls or hide fraudulent activities.
- A forensic audit looks at the detail of a specific aspect of an organization's books and records
  - Objective is to understand why and how fraud has occurred.

Audit Vs. Forensics…2 of 3



- As a result, a forensic audit is much more time consuming and significantly more expensive as a procedure than a regular financial audit.
- Further differences between the traditional and forensic auditing approach are:
  - Not limiting the scope of the engagement based on materiality.
  - Not accepting sampling as evidence.
  - Not assuming management has integrity.
  - Seeking the best legal evidence.
  - Complying with rules of evidence.

Audit Vs. Forensics…3 of 3



Audit

- Event transpires PRIOR to issue of FS
- No assumption that fraud has taken place
- Purpose is to assist the reader in reaching a financial decision
- Determine stewardship of Directors

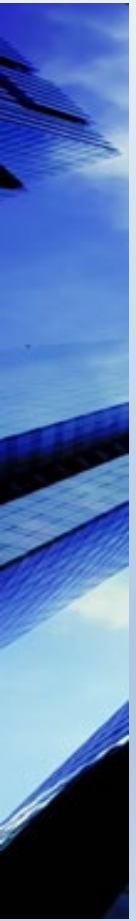
Forensics

- Event transpires following issue
- Assumption that fraud has taken place
- Purpose is to assist the reader in reaching a legal decision
- Establish the culpability of the perpetrator

3. FINANCIAL FRAUDS

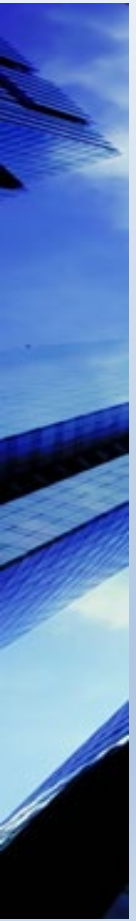
- Financial Statement Fraud
- Types of Financial Frauds
- Case Studies – Past Incidents

Financial Statement Fraud



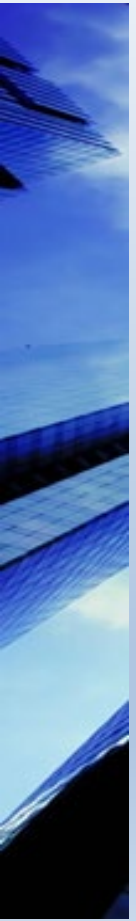
- Financial statement fraud is a deliberate misrepresentation, misstatement or omission of financial statement data for the purpose of misleading the reader and creating a false impression of an organization's financial strength.
- Public and private businesses commit financial statement fraud to secure investor interest or obtain bank approvals for financing, or as justification for bonuses/increased salaries or to meet/exceed expectations of shareholders.
- Upper management is usually at the center of financial statement fraud because financial statements are created and approved at the management level.

Methods of Financial Statement Fraud



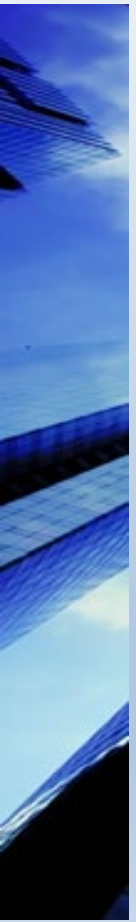
- Fictitious revenues
- Improper asset valuations
- Concealed liabilities and expenses
- Improper disclosures

Scope of Work



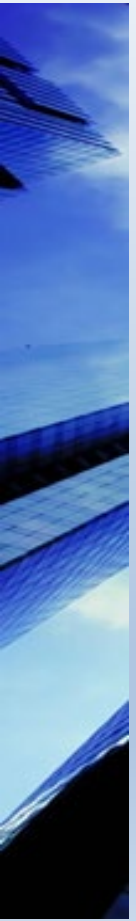
- Tracing the source and genuineness of contribution by promoters by analysing equity/debt/infused by promoters/partners
- Verifying revenue from operations including checking Sales order, invoices and controls in the billing process. The focus should be on unearthing inflated turnover / fictitious sales and/or Sales on Return (SOR) basis where profit has been booked and sales returned in the subsequent accounting period leading to writing off of stocks/debtors and reversal of booked profits
- Verifying receivables- Receivables should be verified thoroughly with a view to unearth 1) reciprocal receivables against each other in case of related parties 2) fictitious debtors 3) inflated debts 4) already realized debts 5) disputed debts 6) unacknowledged debts Sales with conditions (e.g., return)

Scope of Work



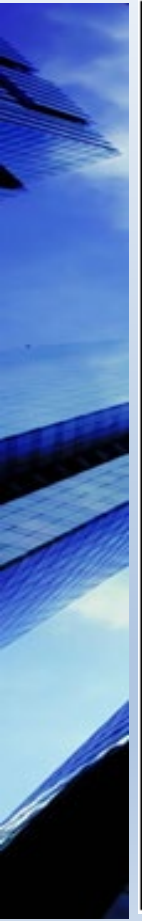
- Verifying the trade payables accounted by the company with actual receipts of the raw material/goods/services purchased and reconciliation of the purchase and inventory of the company with actual manufacturing turnover to ensure that the purchases and sales are not used to inflate the turnover/account liabilities prejudicial to the interest of the company.
- Reviewing the accounting policies and practices adopted by the company and comment on overall accounting system and control including the internal control system in place and find out whether the constituent is conducting its business by complying with the law of the land pertaining to their operations.
- Ascertaining money trail and end use of funds disbursed by lenders

Scope of Work



- To Examine routing of turnover in the accounts (covering areas including the accounts maintained with banks outside consortium, amount of funds routed through member banks vis a vis cash realization and sanction limits)
- Physical Verification of Major Debtors
- Commenting on transactions of Substantial amount, which seems not to be normal trade transactions at arm's length
- Details of Substantial debts raised in sister / associate / group companies either through corporate guarantee of borrower or against security of promoters or promoter's family assets
- Movements in Unsecured loans during the specified period.
- Examining discreetly chain of transactions pertaining to Unit / Promoters / Partners to ensure genuineness of the dealings as there could be case of bogus / family / Other Settlement transactions

Scope of Work



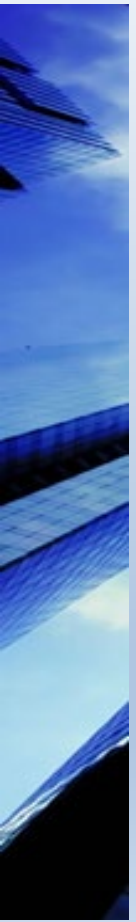
Sections of the Code	Subject Matter	Approach

Sections 43 & 44	Preferential transactions	• Analysis of nature of related party transactions and their impact on the financial statements
		• Verification whether payments / receipts have been done in accordance with the transaction
		• Impact of any offset journal entries that may have been passed and its impact
		• Investigation of preferential transactions (not at arms length) between entities that have taken place in the following manner:
		  ○ In case of related parties – two years prior to the date of insolvency
		  ○ In any other case – one year prior to the date of insolvency
		• Examination of transfer of property / assets/ interest to the benefit of a particular creditor / beneficiary in the presence of an existing debt/ liability such that the creditor is in a beneficial position at the time of distribution of assets
		• Genuineness of the nature of funds / loans given / received from parties
		• Authenticity of the claims made by related party creditors
		• Supporting the legal team in making applications to the Adjudicating Authority

Sections 45 to 49	Undervalued Transactions	• Evaluation of transactions that have occurred which are significantly less than the value of consideration. • Benchmarking such transactions carried out by the company with peer companies (similar industry) to comment on whether they were carried out at arm's length • Review of transfer pricing orders • Quantification and nature of such transactions • Supporting the legal team in making applications to the Adjudicating Authority

Scope of Work

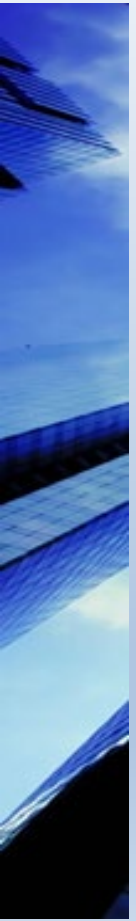
Sections of the Code	Subject Matter	Approach
Section 50	Extortionate credit transactions	• Ascertaining the nature of receipts of any financial or operational debt during the period within two years preceding the insolvency commencement date • Terms & conditions of such debt (interest rate, repayment terms, security interest etc.)and determine if the same is exorbitant in nature • Whether the parties who provided the loan are genuine parties or are in effect related parties?
Section 66	Fraudulent and wrongful trading	• Observation of any apparent fraudulent activity by analyzing the financial statements and other supporting documentation • Identification of areas where fraudulent transactions may have occurred • Analyzing additional data based on the findings



Fictitious revenues

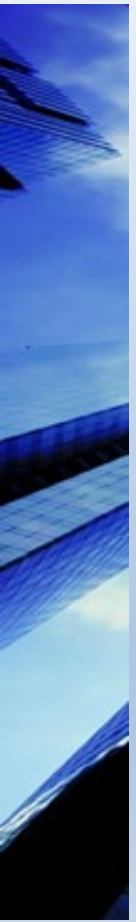
- Recording sale of goods where ownership has not passed to customer
- Recording the sale of services that have not been fully earned (AS – 7 -Unbilled revenue)
- Sales with conditions (e.g., return)
- Use of fake or phantom customers
- Special deals at end of period

Fictitious revenues – Red Flags



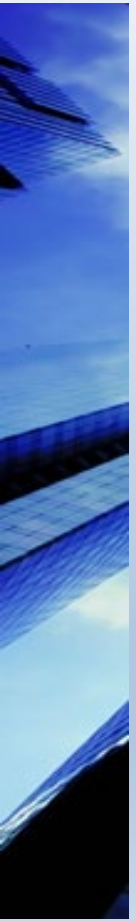
- Rapid growth or unusual profitability, especially compared to that of other companies in the same industry
- Significant transactions with related parties or special purpose entities
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions (eg – Trading concerns)
- A significant volume of sales to entities whose substance and ownership is not known (eg – Proprietorship Firms)

Improper Asset Valuations



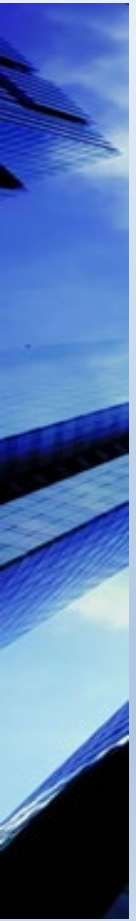
- Under/overstating assets to either:
  - Inflate the asset base (e.g., for loan security)
  - Deflate the asset base (to expense capital expenses and get tax write-offs)
- Misreporting between Capital in Progress with Fixed Assets
  - To manipulate depreciation expenses
- Showing Long-term assets as Short-term or vice-versa to manipulate working capital

Improper Asset Valuations – Red Flags



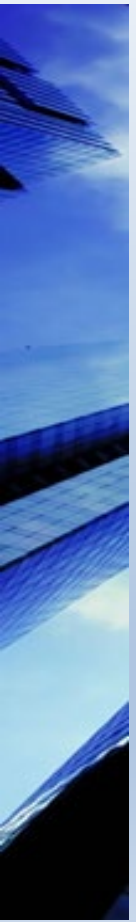
- Asset Valuations based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
- Executive management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates
- Allowances for bad debts, excess and obsolete inventory, and so on that are shrinking in percentage terms or are otherwise out of line with industry peers
- Unusual change in the relationship between fixed assets and depreciation.

Concealed Liabilities and Expenses



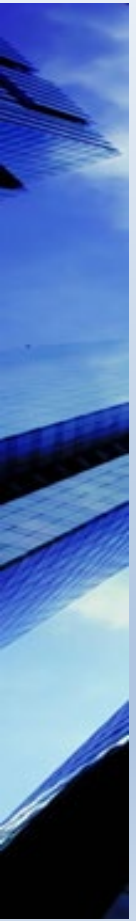
- Liabilities treated as contingencies
- Deferred payment obligations not recorded

Concealed Liabilities – Red Flags



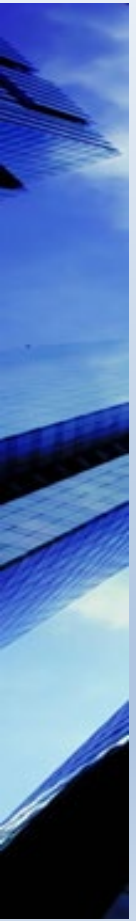
- Significant payments to vendors/third parties after year-end for past unrecorded liabilities.
- Letters of Commitments / Undertakings not recorded or reconciled with third parties:
  - Treated as contingency (e.g., Nirav Modi/PNB)
- No independent verification with vendors or third parties
- Expensing of significant costs of prior periods for regular operations.

Improper Disclosures



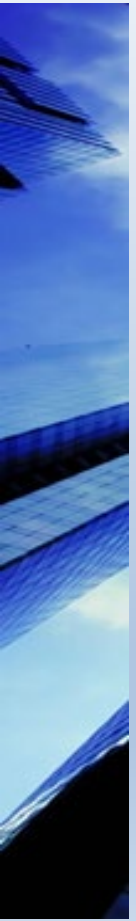
- Where notes to the accounts are inconsistent or incomplete with the financial statements
- Where disclosures cover part and not the full aspect of the situation
  - Form over substance (mere compliance)
- Suppression of full information which might throw a different light on the transactions and / or arrangements (eg Related Parties)

Improper Disclosures – Red flags



- Changes to Financial Statements/notes at the insistence of executive management
- Known history of violations of securities laws or other regulations, or multiple claims against the entity, its senior management, or board members
- Significant bank accounts or subsidiary or branch operations in tax haven jurisdictions for which there appears to be no clear business justification
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority
- Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee (Internal & External)

Past Incidents of Financial Frauds

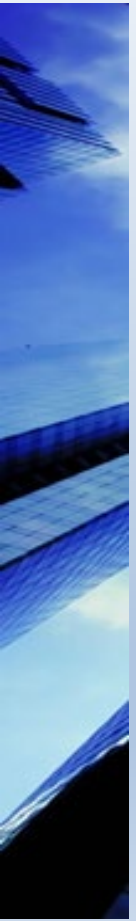


- Some of the greatest accounting incidents of all time have rocked the financial and even political worlds with their repercussions.
- These have been felt across continents.
- A majority of these scandals are perpetrated on investors of the organization in question.
- Investors were often misled and are forced to believe that organization's financial situation is sound.
- However, this was not true.

4. INVESTIGATION PROCESS

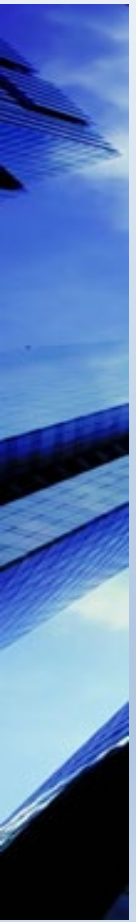
- Accepting the assignment
- Planning
- Execution
  - Evidence Gathering
  - Interrogation
- Reporting
- Court Proceedings

Accepting the Assignment



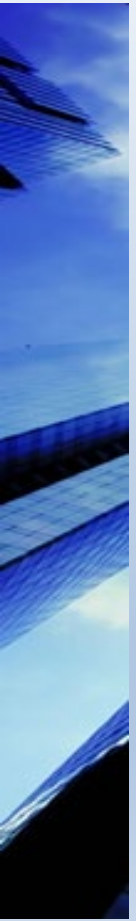
- To accept the assignment, the Forensic accountant must ensure whether they have the required expertise, e.g.,:
  - Necessary forensic skills
  - Interrogation skills of suspects
  - Experience on past cases of similar nature
  - Some prior exposure to similar industry or business

Planning the Assignment



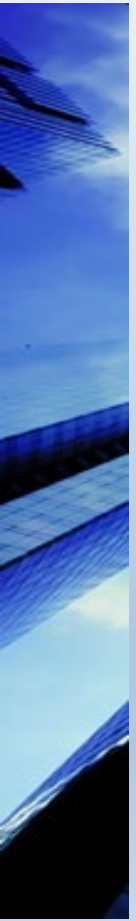
- Objectives of a typical forensic assignment include:
  - Identify type and nature of the fraud
  - Understand the modus operandi (how it was perpetrated)
  - Identify suspects (the fraudsters and the mastermind)
  - Gather evidence
  - Quantify the loss (estimates must have good basis)
  - Provide advice to prevent the re – occurrence.

Executing the Assignment



- Gathering Evidence
  - Testing internal controls
  - Use data analytical procedures
  - Apply CAAT or such IT tools
  - Discussion and interviews with relevant people
  - Substantive financial techniques, such as reconciliation, cash counts and review of stocks
- Interrogation
  - Understand the individuals and their background
  - Make checklist of questions
  - Generally use two persons – good cop/bad cop approach
  - Always get a written statement – preferably a confession

Reporting Results

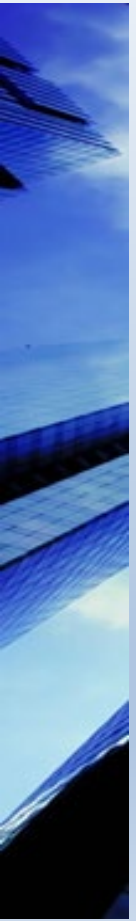


Report should be comprehensive, but to the point.

Key contents are:

- Findings/ Observations
- Summary of evidences
- How fraudsters set up fraud scheme and which controls were circumvented
- Amount of loss
- Summary of statement of key persons
- Recommend improvements of controls (for future prevention)

Court Proceedings

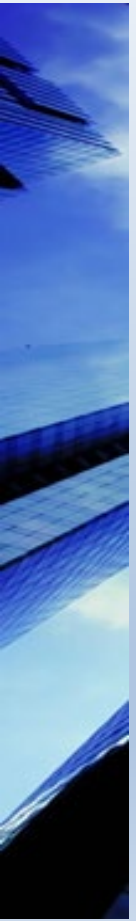


- Forensic accountants do not testify that fraud has occurred but only present evidence
  - Evidence should be compelling to confirm the fraud
- Only member of investigation team are involved
  - Generally senior person should present
- All the evidence collected and gathered is presented, in logical sequence
- Important to simplify technical terms and explain the modus operandi

5. FRAUD PREVENTION

- Anti Fraud Measures
  - Fraud Triangle approach
- Vigilance Mechanisms
  - Whistle Blower Mechanism
- Disciplinary Activities
- Code of Conduct and Certification

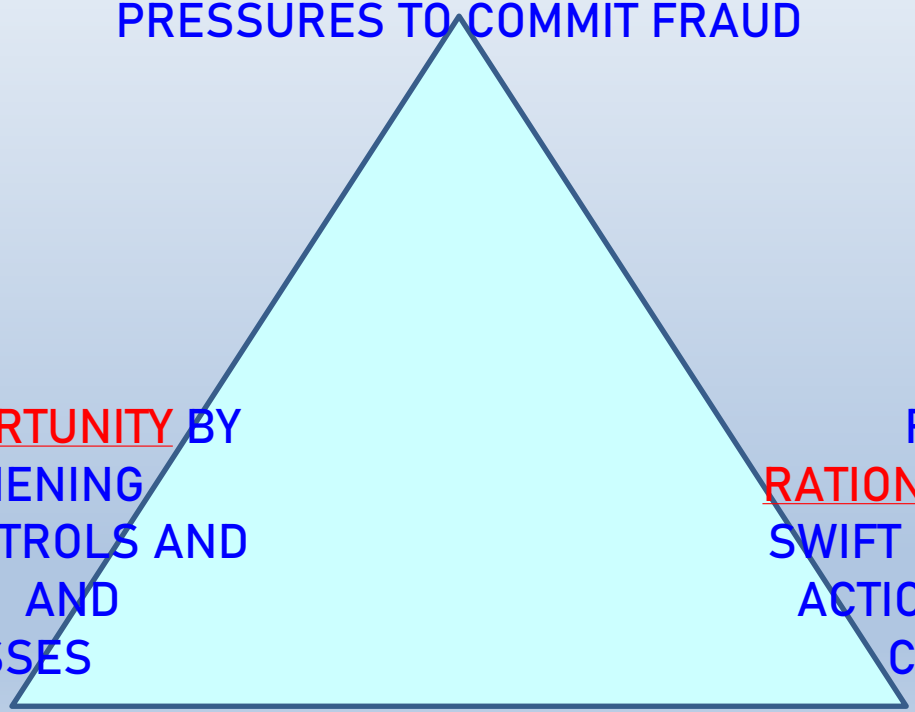
Fraud Prevention



- Frauds are best controlled through comprehensive fraud prevention measures.
- Most companies deploy high level anti-fraud measures to display a “culture of compliance” and “zero tolerance” towards such incidents
- For culture of compliance, most companies have in place a CODE OF CONDUCT which spells out the “do’s” and “don’ts” so that there is clarity on permissible and prohibited actions (ethical culture)
- For displaying zero tolerance, companies have strong Disciplinary Measures so that timely action/punishment is taken against culprits

Fraud Prevention –Triangle approach

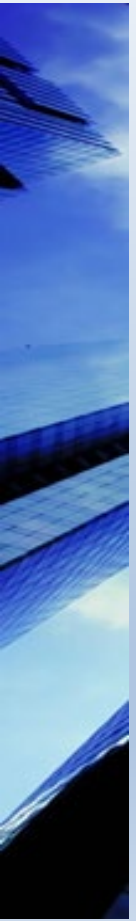
REDUCE MOTIVE OR
PRESSURES TO COMMIT FRAUD



REDUCE OPPORTUNITY BY
STRENGTHENING
INTERNAL CONTROLS AND
SYSTEMS AND
PROCESSES

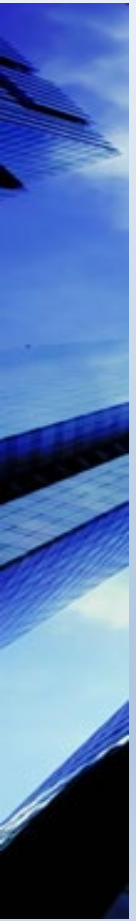
REDUCE
RATIONALISATION BY
SWIFT DISCIPLINARY
ACTIONS AGAINST
CULPRITS

Reduce MOTIVE



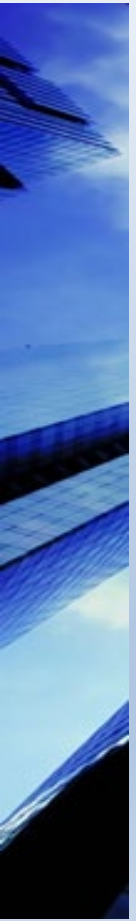
- Establish effective board oversight and an effective “tone at the top”
- Manage/discourage excessive external expectations of future corporate performance
- Ensure compensation systems are fair and do not create incentives to commit fraud
- Set only achievable (but stretch) performance goals and monitor pressure from superiors to achieve those goals
- Remove operational obstacles blocking effective performance

Reduce OPPORTUNITY



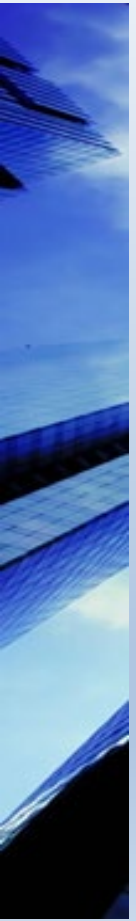
- Strengthen Systems and Processes and Internal Controls
- Monitor business transactions and interpersonal relationships between employees and external parties
- Establish strong physical security systems (e,g., CCTV) to prevent loss of company assets, including finished goods, cash, capital equipment, tools, and other valuable items
- Encourage strong supervisory and leadership relationships within groups to ensure enforcement of accounting controls and full compliance
- Maintain a periodic internal audit mechanism.

Reduce RATIONALISATION



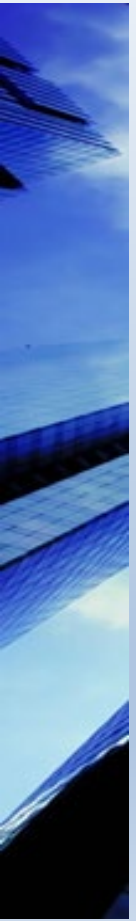
- Promote strong values, based on integrity, throughout the organization.(Ethics, Codes, Standards)
- Have policies that clearly define prohibited behavior with respect to accounting and financial statement fraud.(Ethics and Fraud policy)
- Provide regular training to all employees communicating prohibited behavior. (Professional Development)
- Maintain accurate personnel records including background checks on new employees.(Keep high integrity employees only)

Whistle blower



- A whistleblower is a person(s) who has valuable information and reports insider knowledge of illegal activities occurring inside the organization.
- Whistleblowers can be employees, suppliers, customers or any business partners.
- Contractors, clients or any individual who becomes aware of illegal or fraudulent activities taking place in a business either through witnessing the behavior or being told about it.

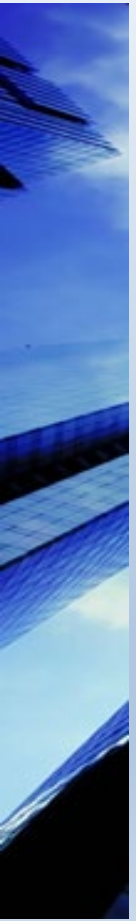
Whistle blower Mechanism



The organization needs to implement the WB mechanism keeping the following in mind:

- Widely publicize the policy and mechanism (on website)
- Maintain anonymity of the complainant
- Ensure confidentiality of information reported through the whistle-blower mechanism
- Ensure a policy of non-retaliation against the whistle-blower
- Actions that can be initiated based on the nature and seriousness of the issue reported
- Issues that are “not serious” taking up senior executives’ time.

Disciplinary Activities

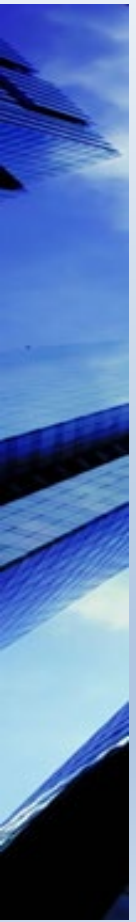


The company should take quick and strict actions against those who are found to be in violations of policies:

- Policy on Violation should be in place
  - Clearly communicate consequences of violations
- The severity of punishment should depend on nature and severity of violation
  - Some leniency towards first time offenders
  - Written apologies should be taken and kept in record
  - Repeat offenders should be put on notice
  - All unlawful gains should be recovered
- Follow “natural justice” procedures and ensure show-cause notices in writing
- Consider making example in some cases
  - but avoid “naming-shaming”

6. CONCLUSION

Conclusion



- Fraud is an epidemic and requires to be treated in a highly specialized manner.
- Forensic Audit is a specialized type of engagement, Auditor cum Investigator
- Investigations requires skilled and experienced team
- All financial frauds will require expertise of accounts and finance
- IT can play a powerful role in undertaking forensic investigations in evidence collection
- Forensic teams may be required to appear in court proceedings and testify
- Exception to the clause: ‘ auditors can be watchdogs and not blood- hounds’.

ANY QUESTIONS?

THANK YOU!

CA Rahul Jindal

FCA, LLB, DISA, Certified Fraud Examiner, Certified Forensic Auditor, Certified Valuer, Certified Concurrent Auditor, Dip(IFRS)

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