



Refresher Course on Forensic Accounting and Investigation *Detection, Investigation & Prevention of Financial Frauds & Crimes*

For Western India Regional Council of ICAI

08 July 2021

Private and Confidential



KROLL

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HOW TO PRE EMPT
FRAUDS KROLL

Fraud: *wrongful or criminal deception intended to result in financial or personal gain**

Source: Oxford Dictionary

Definition of fraud as per Companies Act 2013

“fraud” in relation to affairs of a company or any body corporate, includes

(a) any act,

(b) omission,

(c) concealment of any fact or

(d) abuse of position committed by any person or any other person with the connivance in any manner, -

i. with intent to deceive,

ii. to gain undue advantage from, or

iii. to injure the interests of,

a. the company or

b. its shareholders or

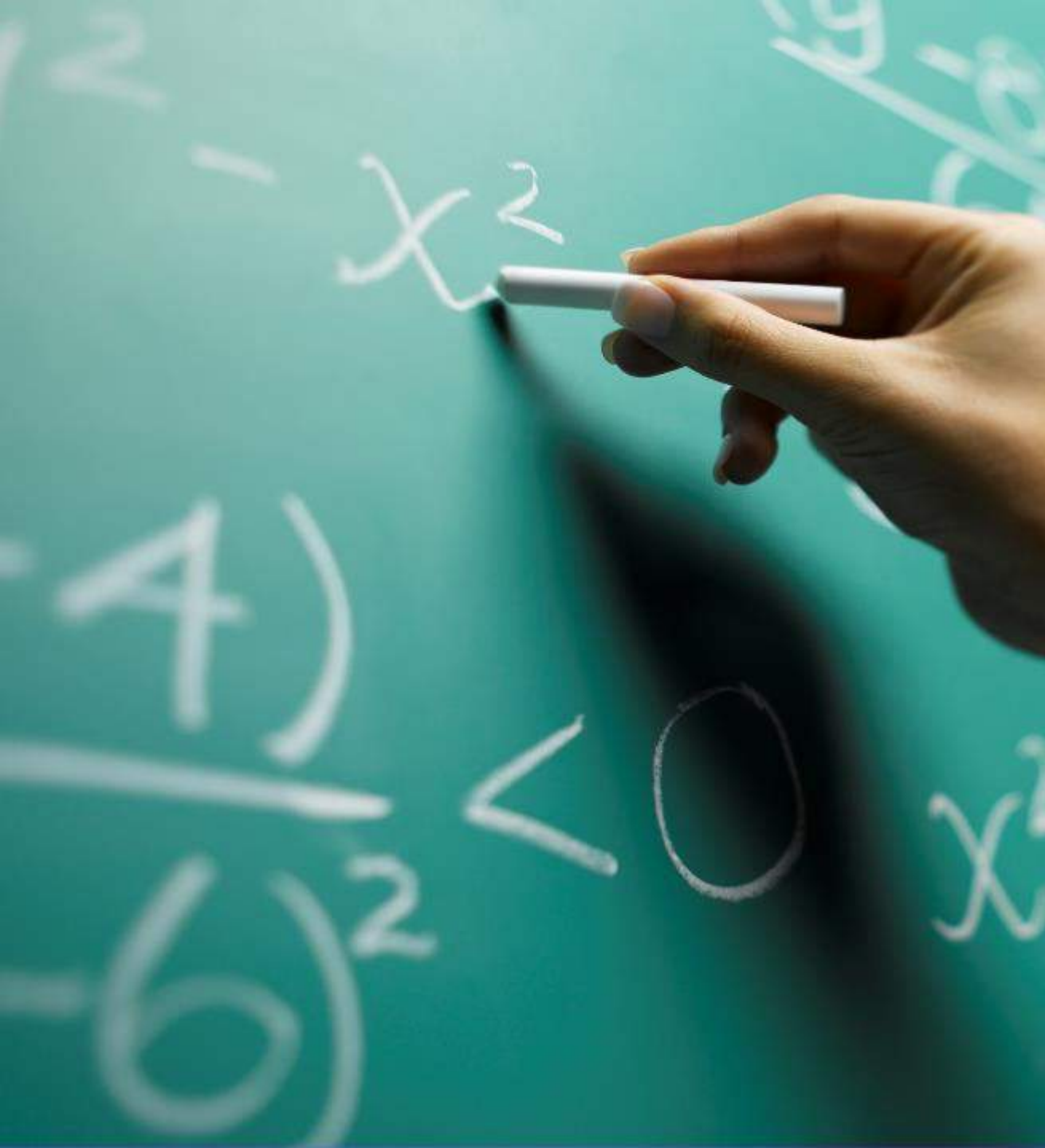
c. its creditors or

any other person,

whether or not there is any wrongful gain or wrongful loss;

- “*wrongful gain*” means the gain by unlawful of property to which the person gaining is not legally entitled;

- “*wrongful loss*” means the loss by unlawful means of property to which the person losing is legally entitled.

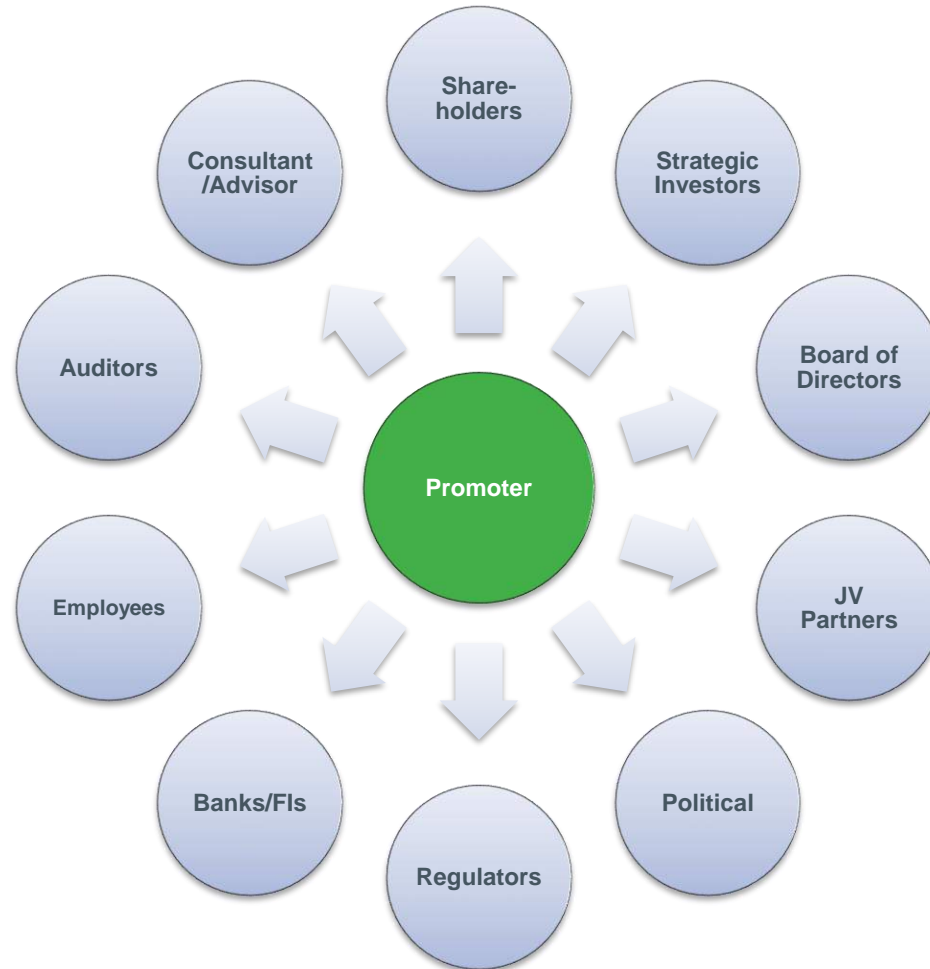


01

Factors driving
frauds in India

Factors driving frauds in India

Promoters are at the center of all relationships; Remote Control



India's Business Environment: Unique Challenges

- **Corporate governance standards are still evolving**
 - Lack of segregation of duties, absence of code of conduct, limited whistle blowing mechanism, and weak internal audit functions
 - Close nexus between politicians, bureaucracy and business compromises ethical operating standards
 - Several cases of investors facing 'bad faith' practices from local partners, subsidiaries and competitors
- **Local accounting and auditing practices have not fully matured**
 - Over-reliance of internal and external auditors on management representations
 - Auditing tools are not customized to the Indian operating environment (e.g., family owned businesses)
 - ERP systems are often ineffective in driving transparency
- **Poor regulatory oversight**
 - India's regulatory systems are complex and ever-changing (tax, environmental, competition laws)
 - The complex judicial system makes it difficult for investors to enforce agreements and punish non-compliance
 - Cannot rely on courts or arbitration to resolve disputes in a timely manner

The result:

1. Lack of good quality information on business practices
2. Key accounting and performance related data can be manipulated relatively easily
3. Investors may be exposed to reputation-related and regulatory risks
4. Good investments may not be getting done due to insufficient or conflicting information



02

Common themes
across domestic
and global frauds

Some of the major reported corporate frauds in India

Common themes

- IL&FS – related party transactions and use of intermediaries
- Dewan Housing - related party transactions, fictitious transactions and end use of funds
- Satyam Computer Services – misreported increased sales and higher profit margins; falsified cash balance
- Nirav Modi – unauthorized LCs and end use of funds
- Fortis – related party transactions
- Ricoh India - Fictitious sales to inflate revenues; high bad debts relating to such fictitious sales and wrong accounting
- NSEL - brokers mis-sold products to their clients by assuring them fixed returns; defaulters hypothecated stocks and produced fake warehouse receipts
- Reebok India - fake transactions with unauthorized lenders
- Catmoss - cooking books
- Liliput - Fictitious sales to inflate revenues
- IBM India - forging customer purchase orders and diverting materials sourced for customer deals to the open market

Fraud is a global phenomenon

Enron

The energy company's bankruptcy in 2001 after allegations of massive accounting fraud wiped out \$78 billion in stock market value and led to the collapse of Arthur Andersen and the passage of the Sarbanes-Oxley Act of 2002. A class action settlement of \$7.185 billion was the largest of all time. Former President Jeff Skilling is serving a 24-year sentence.

Bernard Madoff

New York money manager Bernard Madoff's \$65 billion Ponzi scheme, the largest fraud ever by an individual, was exposed in December 2008. The case led the SEC, which missed several opportunities to stop the fraud, to focus on Ponzis and investment advisor fraud. Madoff is doing 150 years in prison

Lehman Brothers

Investment bank Lehman, with \$600 billion in assets, failed in late 2008. It was the largest bankruptcy in history and a spark to the worldwide financial crisis. A bankruptcy examiner's report concluded there were "colorable" claims against its top executives and its auditor, Ernst & Young, for fraud, but neither the SEC nor the DOJ have so far filed charges.

Tyco International

CEO Dennis Kozlowski and CFO Mark Swartz soaked Tyco for more than \$150 million in unearned bonuses and loans from 1996 until 2002. Class action lawsuits cost the company another \$3.2 billion and both are still in jail

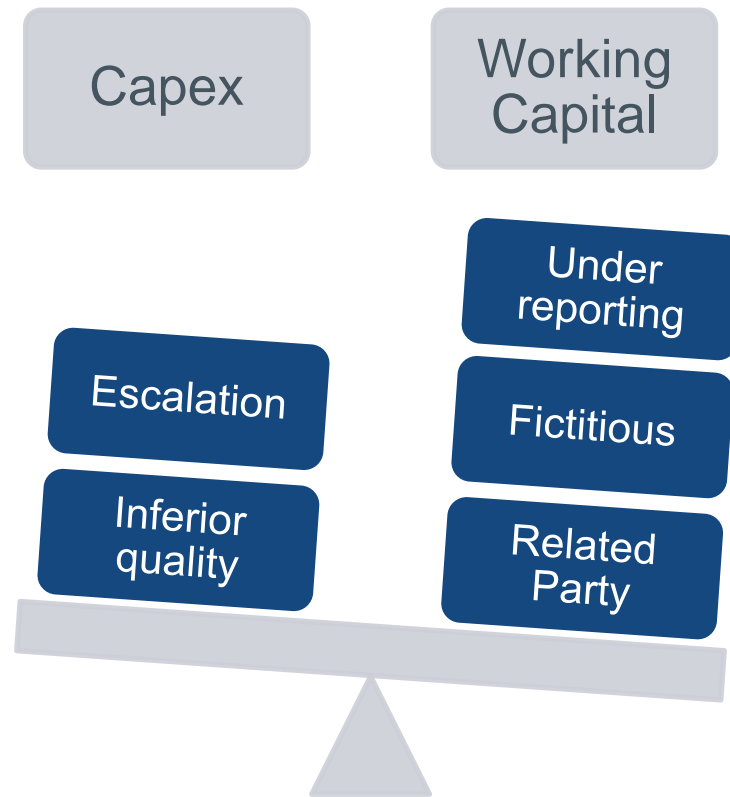
Types of bank frauds

- Bank-related frauds - Indian banks lost over INR 100,000 Cr (over the past three fiscals) to various types of frauds. There is more.
- Banks face serious internal as well as external challenges
 - External – client’s misrepresentation, cheating, siphoning, accounting fraud
 - Internal - collusion, data theft, identity theft, embezzlement.
- The common types of frauds seen in banks are

Fraudulent loans	Phishing and Internet fraud
Fraudulent use of loans	Money laundering
Wire fraud	Forged currency notes
Accounting fraud	Cyber fraud
Bill discounting fraud	Data theft
Credit card fraud	

Frauds in banking system

Working capital frauds outweigh capex led frauds



Leads to fund diversion and unreported asset creation

The background of the slide is a dark blue and purple gradient. It features a complex overlay of digital and financial data. On the left, there are several line graphs with red and white lines, and bar charts with red bars. Scattered throughout the background are glowing binary digits (0s and 1s) in various colors, including cyan, white, and red. The overall aesthetic is high-tech and data-driven.

03

Fraud
Investigations &
Forensic Audits

Forensic Audit

A forensic audit is an examination and evaluation of a firm's or individual's financial records to derive evidence that can be used in a court of law or legal proceeding.

Scope of Work – Forensic Audit

Typical Scope used for Forensic Audit

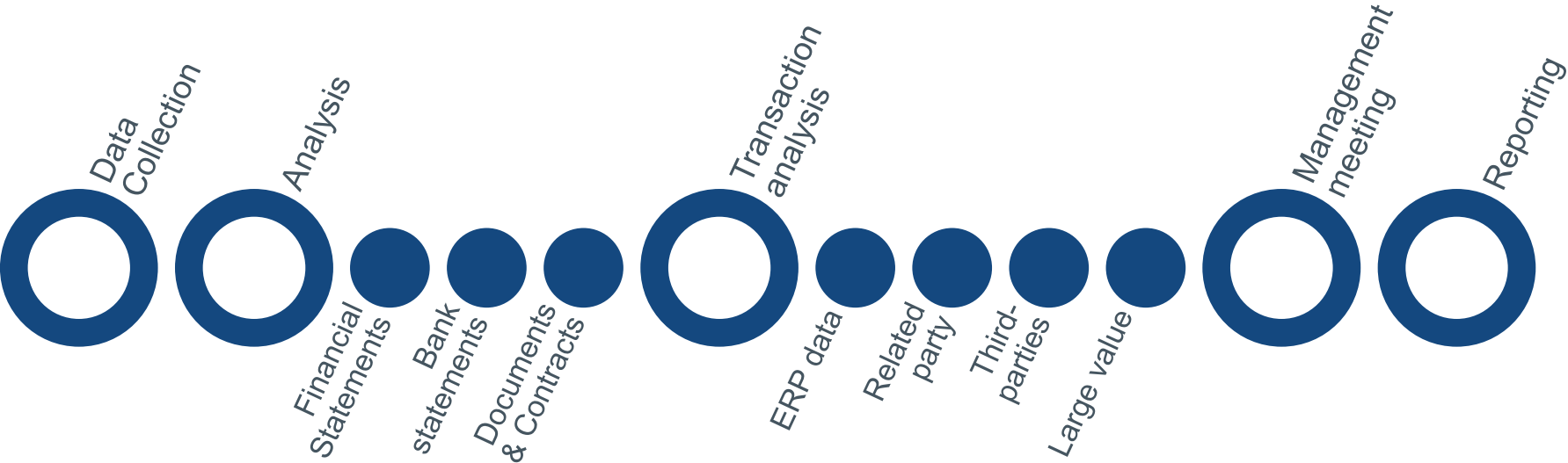
No.	Scope
1	Ascertaining money trail and end use of funds disbursed by lenders
2	Tracing the source and genuineness of contribution by promoters by analyzing equity/debt/ infused by promoters/partners
3	Verifying revenue from operations including checking sale order, invoices and controls in the billing process.
4	Commenting on transactions of substantial amount, which seem not to be normal trade transactions at arms' length
5	Commenting on adherence to Escrow/Trust and Retention Account (TRA) arrangements made with various Banks. Details of all transactions with banks outside the consortium/other than nominated account
6	Concentrating transactions - sole customer, sole supplier, major transactions with related parties/group companies. Analysis of relationship in two-way deals with the same party or indirect payments made by customers of the borrower to the vendors of borrower
7	Movements in unsecured loans during the specified period
8	Analysis of findings of Special Audit if any
9	Verifying receivables to understand reciprocal receivables against each other in case of related parties, fictitious debtors, inflated debts, already realized debts, disputed debts and unacknowledged debts

Scope of Work – Transaction Review under IBC

Examining transactions of Corporate Debtor as per the IBC Sections – 43, 45, 50 and 66

Category	Scope of Work
Preferential Transactions (Section 43)	<p>Identifying preferential transactions, if any (subject to allowable exceptions)</p> <ul style="list-style-type: none">• Where there has been transfer of property or an interest thereof of the Corporate Debtor for benefit of a creditor or a surety or a guarantor for or on account of an existing financial debt or operational debt of a creditor or other liabilities owed by the Corporate Debtor, and• Where such transfer has the effect of putting such creditor or a surety or a guarantor in a beneficial position than it would have been in the event of distribution of assets being made in accordance with Section 53 of the Code
Undervalued Transaction (Section 45)	<p>Identifying undervalued transactions, if any</p> <ul style="list-style-type: none">• Where the Company made any gifts to a person, or entered into a transaction with a person which involved transfer of one or more assets by the Company for a consideration the value of which is significantly less than the value of the consideration provided by the Company <p>Identifying any undervalued transactions where such transaction was deliberately entered into by the Corporate Debtor with an objective of defrauding creditors by:</p> <ul style="list-style-type: none">• Keeping the assets beyond the reach of any person who is entitled to make a claim against the Corporate Debtor; or• To adversely affect the interest of such person in relation to the claim
Extortionate/ Fraudulent Transactions (Section 50 and Section 66)	<p>Examining and analyzing transactions involving receipt of financial or operational debt by the Corporate Debtor during the review period to identify any extortionate credit transactions and fraudulent transactions</p>
Background Checks	<p>Conduct limited background checks, predominantly based on public information, on the select entities involved in above transactions to identify any undisclosed relation with the Corporate Debtor</p>

Step-wise approach for forensic audit



Information Needed

Presented below is the list of data typically needed for our review:

Sr. No	Data	Year 1	Year 2	Year 3	Year 4
1	ERP data	X	X	✓	✓
2	General Ledger Accounts	X	X	✓	✓
3	Customer and Supplier ledger accounts	✓	✓	✓	✓
4	Bank Book	X	X	✓	✓
5	Cash Book	X	X	✓	✓
6	Annual Reports	✓	✓	✓	✓
7	Trial Balance	X	X	✓	✓
8	Bank Statements (Operational accounts)	✓	✓	✓	✓
9	Bank Reconciliation statements	X	X	X	✓
10	Form 26AS	X	X	✓	✓
11	Balance Confirmation from Axis Bank	✓	✓	✓	✓
12	Arbitration filings	✓	✓	✓	✓
13	Secretarial reports	✓	✓	✓	✓
14	Assessment or scrutiny orders	X	✓	✓	X
15	Goods and Service Tax details returns	X	X	X	✓

Timelines for executing forensic audit

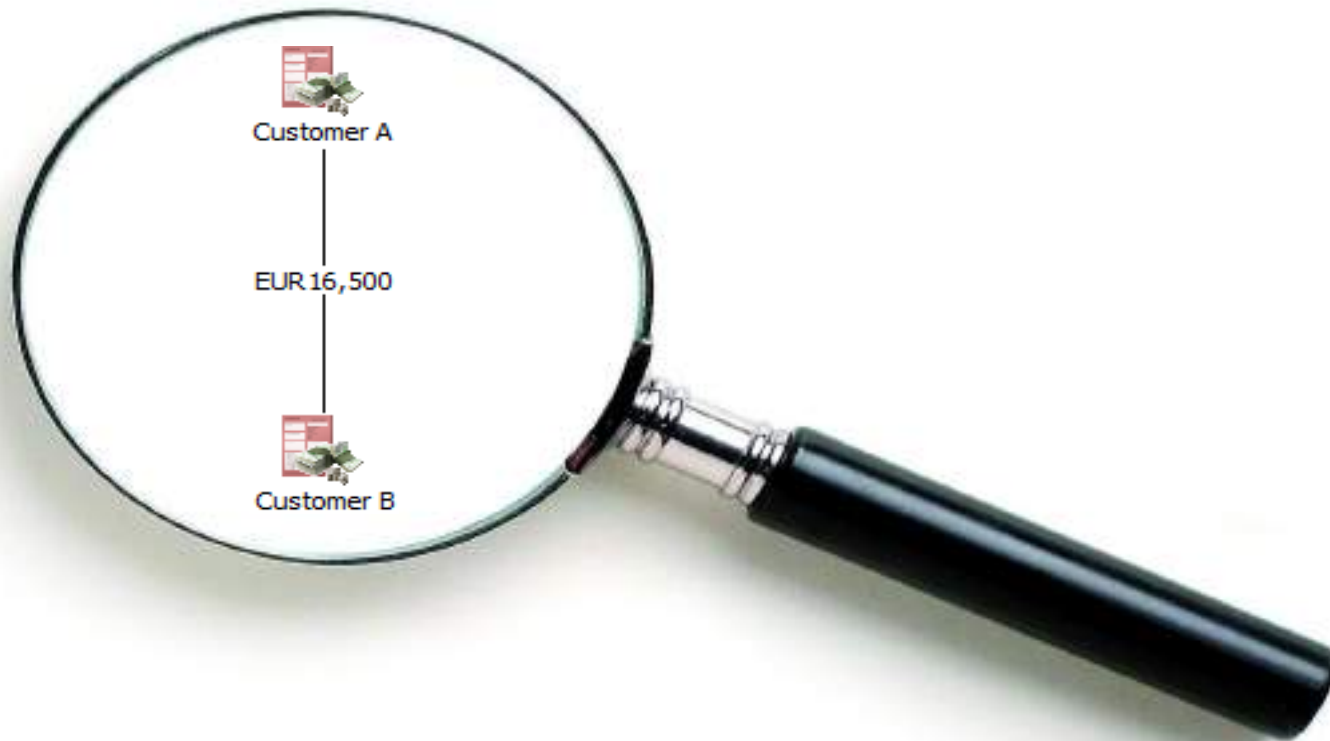
Action	Particulars	Tentative timeline
Kick-off meeting and information gathering	Initiate the assignment with a kick-off meeting with nominated representatives of Corporate Debtor and Bank/RP	Week 1-4
Ongoing information gathering and data review & analytics	<p>Review and analysis of the documents received from the client, which include:</p> <ul style="list-style-type: none"> • Review of the Financial Statements and annual filings of the corporate debtor • General ledger transactions • Review of purchase and sales register • Review of the cash and bank books • Review of the electronic bank statements and verification of the bank balances • Review of the agreements, contracts and litigation filings 	Week 5-10
Reporting	After the completion of the analysis, a report highlighting the red flags that have been identified will be issued	Week 11-14

Tools and Applications used for Investigations

Data Analytics	Forensic Imaging	Email Review
Altrix	Encase	NUIX
R	FTK Imager	Intella
SQL, SQL+	Kalilinux	Relativity
Excel ++	Paladin	MS Outlook
Python	TD2 – Tableau Forensic Imager	
Tableau	Oxygen Forensic Detective	
Qlikview	UFED 4PC	

Transaction Analysis

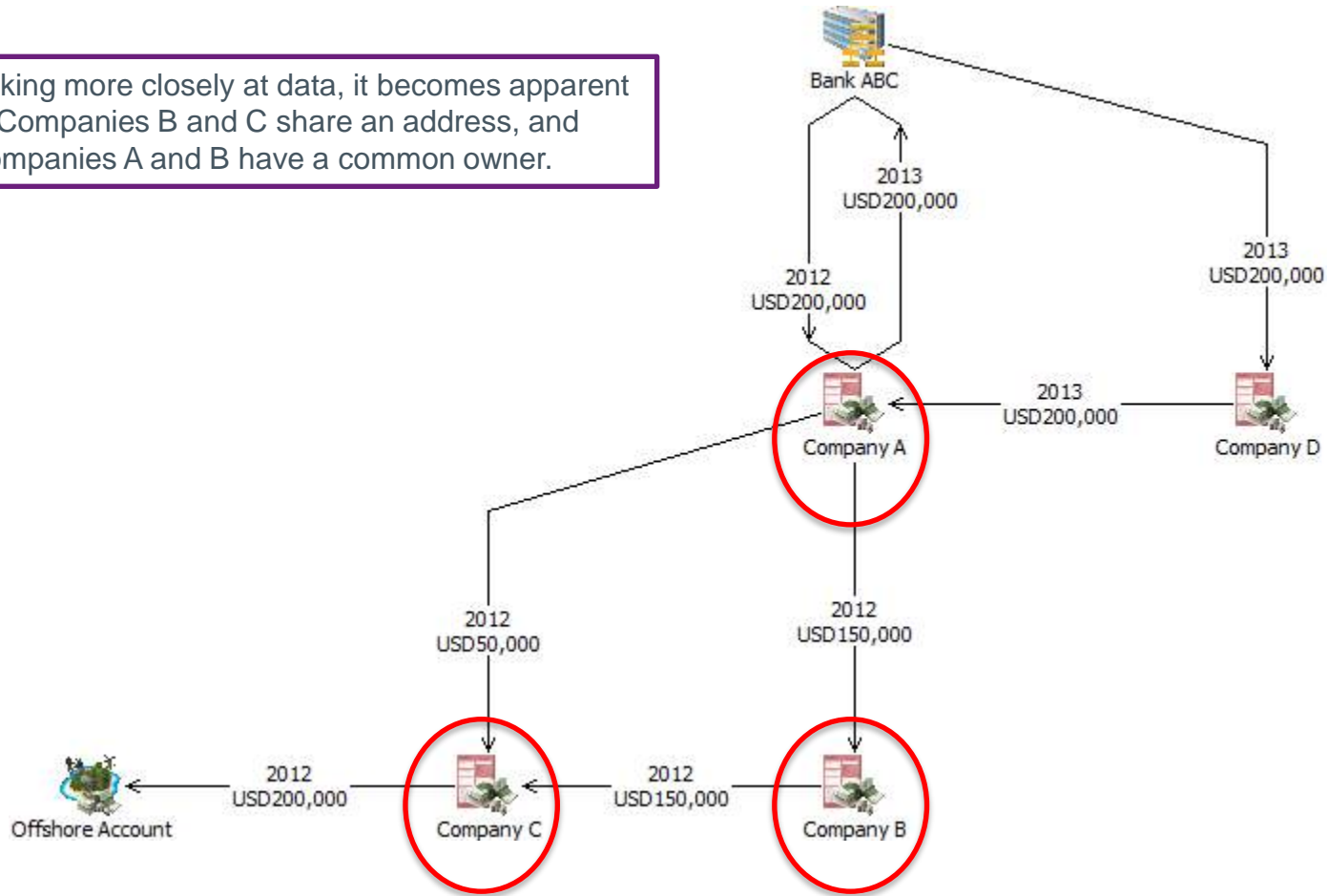
Money Laundering - Small Picture



Transaction Analysis

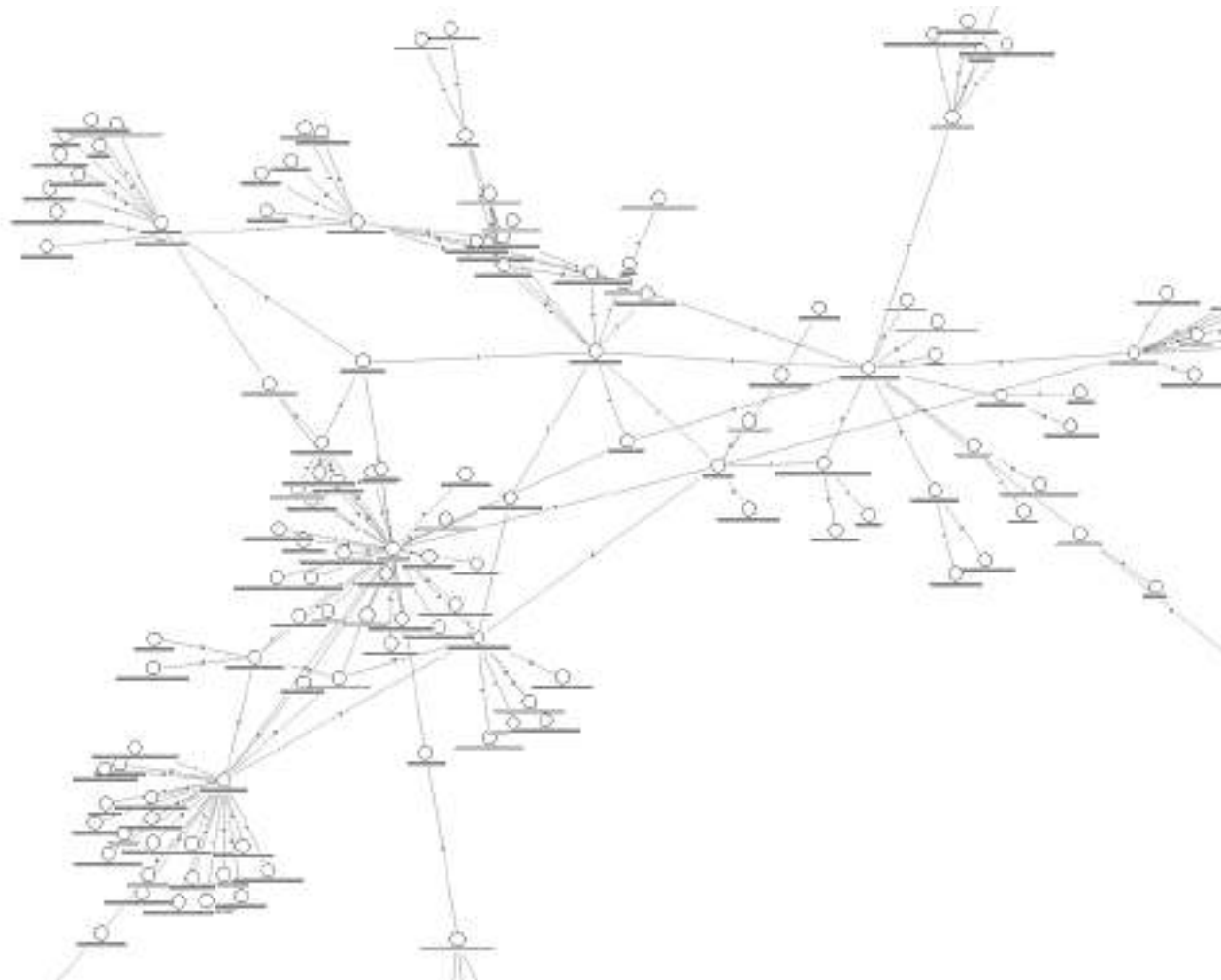
Money Laundering - Bigger Picture

After looking more closely at data, it becomes apparent that Companies B and C share an address, and Companies A and B have a common owner.



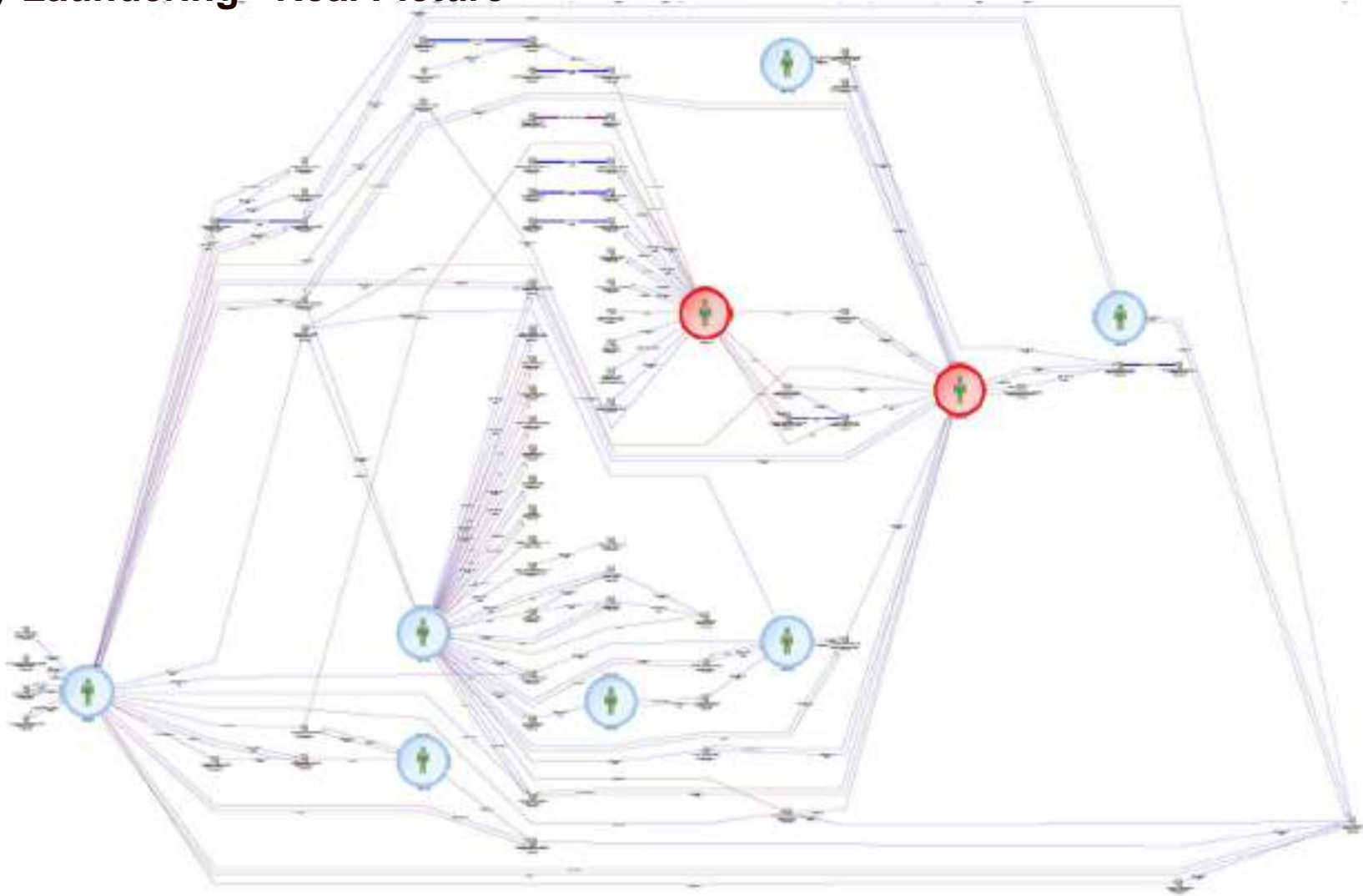
Transaction Analysis

Money Laundering - Real Picture



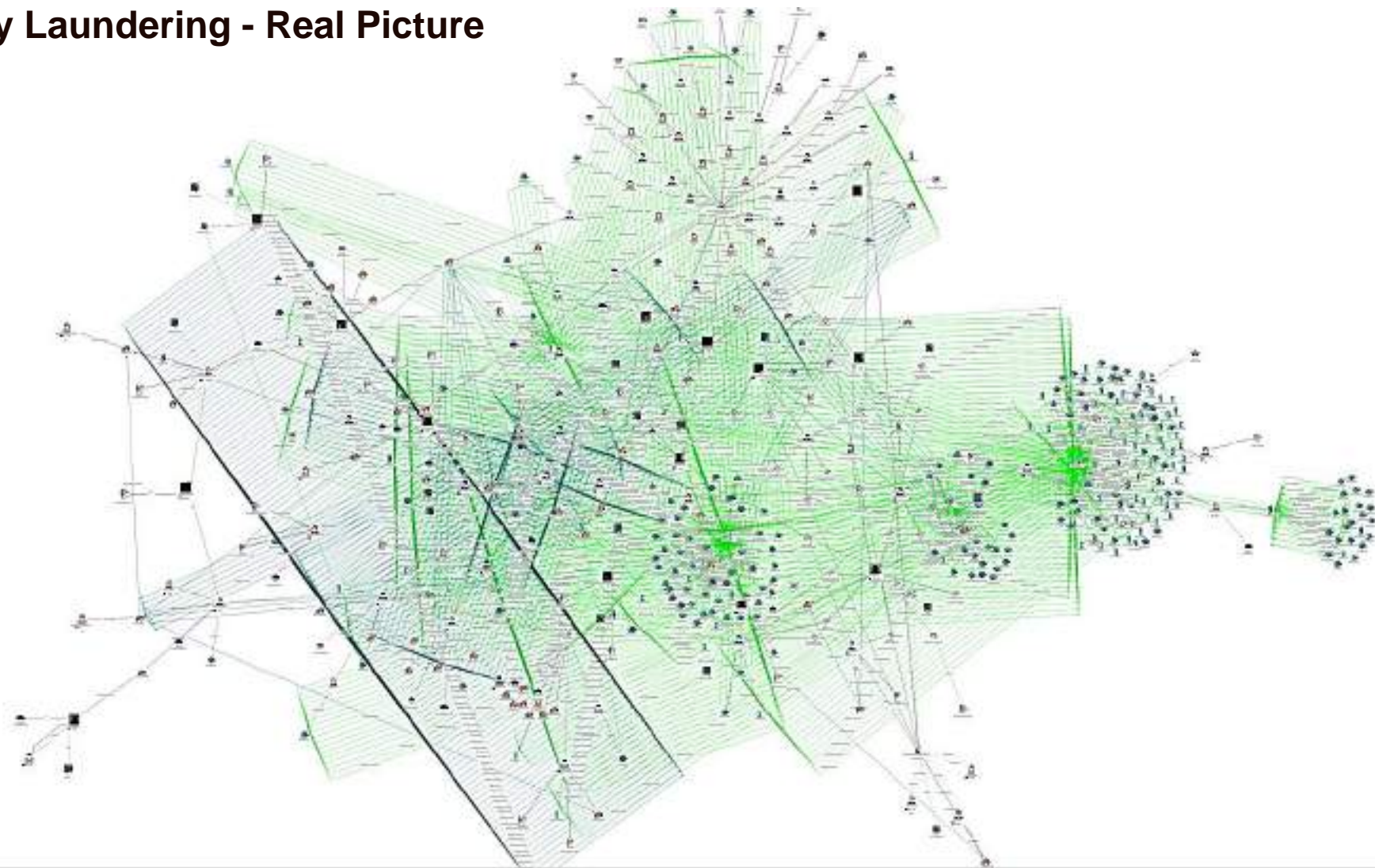
Visual Company Linkages

Money Laundering - Real Picture



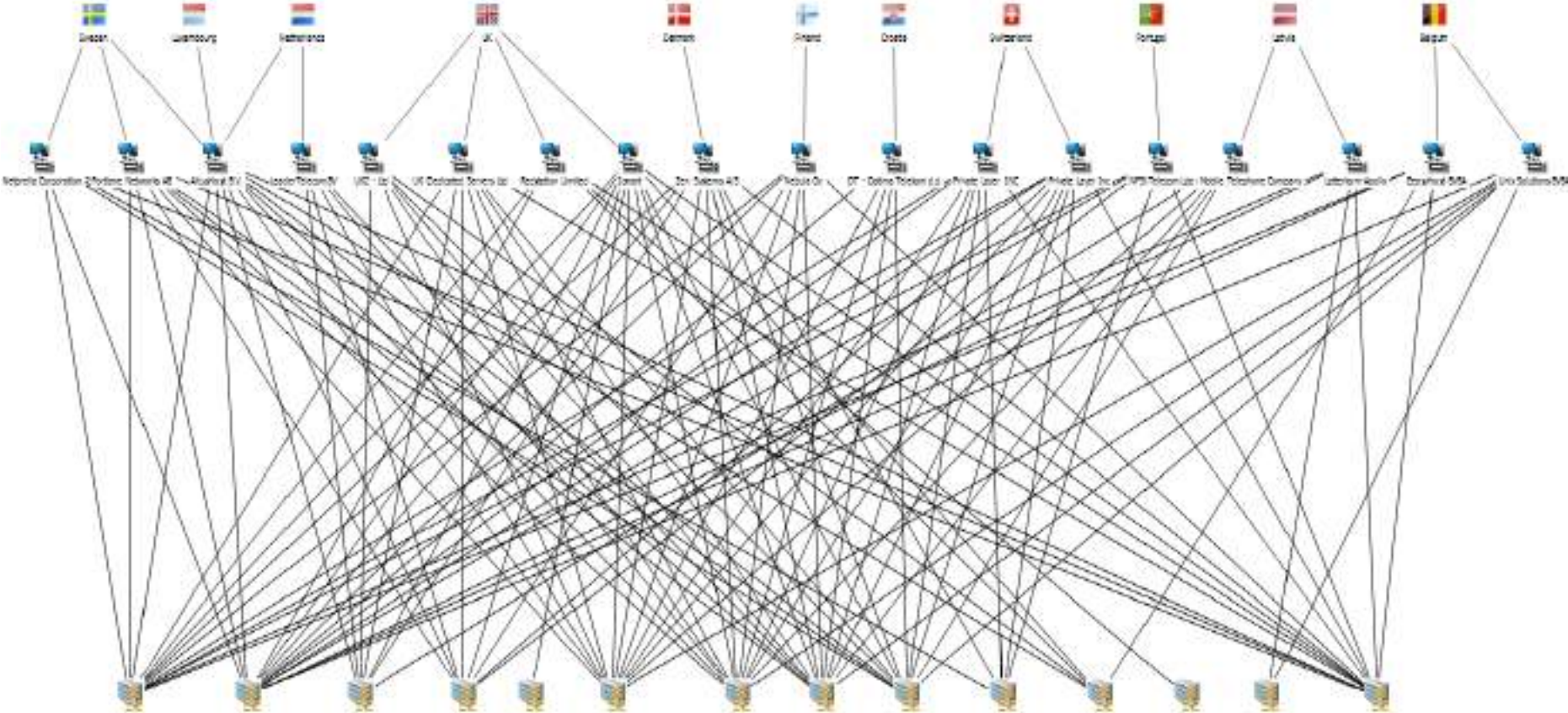
Visual Data Analytics and financial transactions

Money Laundering - Real Picture

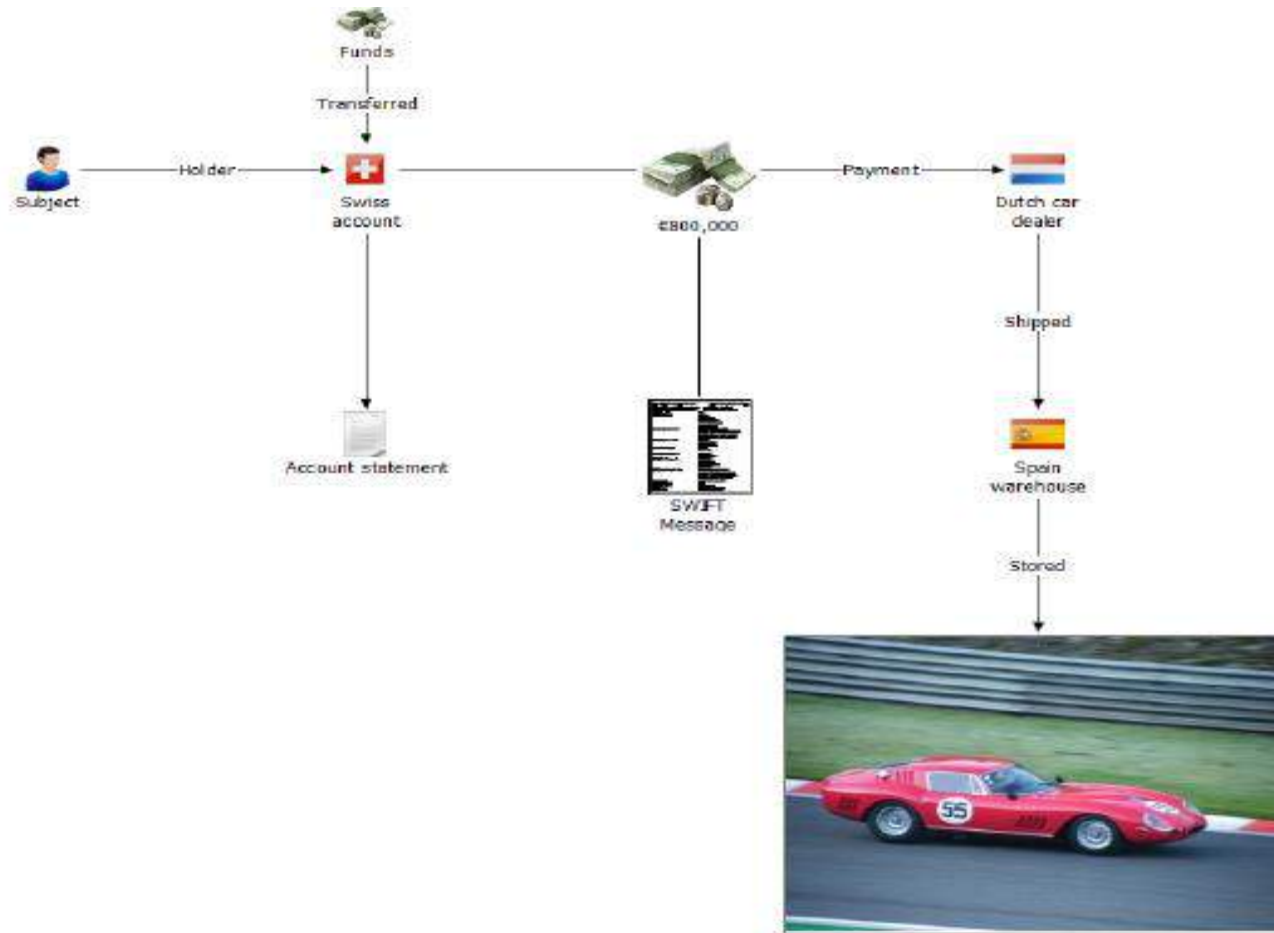


Data Analytics

- Identical IP address for online banking could indicate related parties

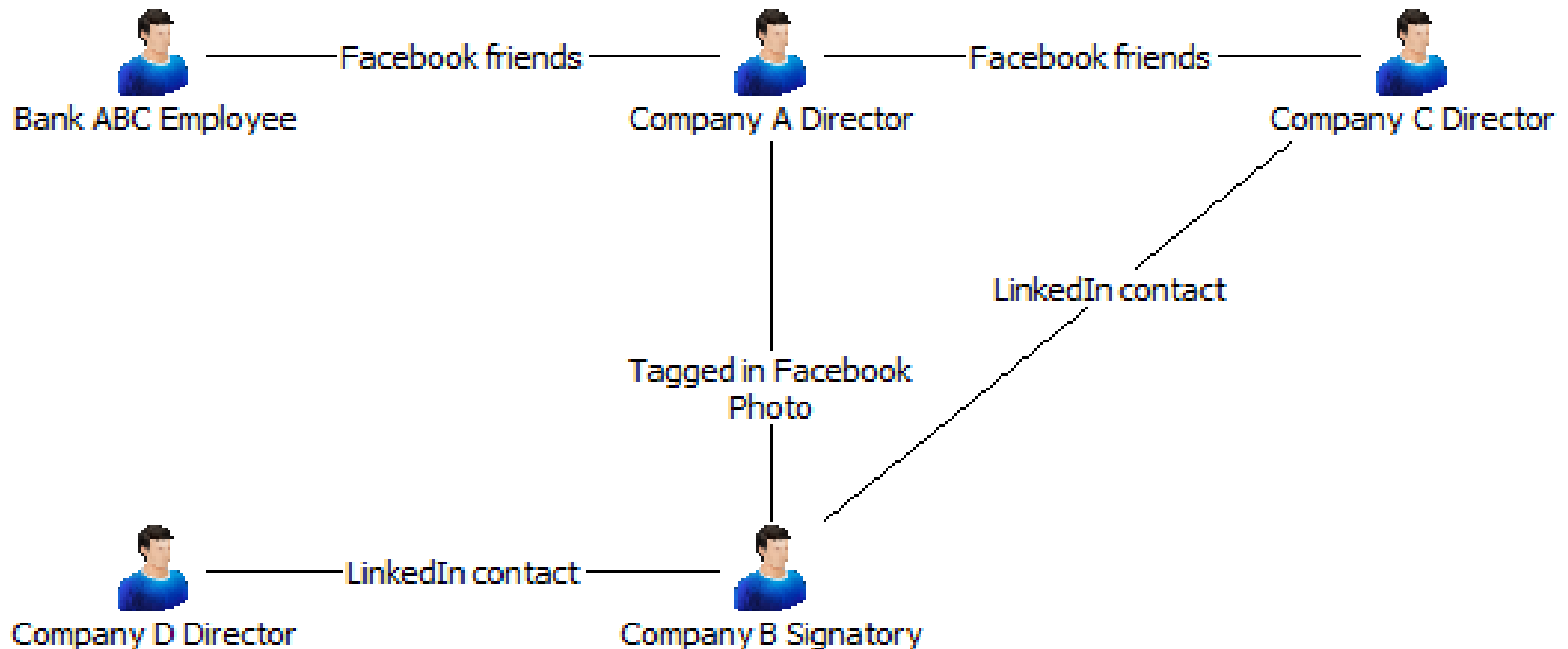


Transaction Analysis



Social Media Analytics

Once it is suspected that the parties are related, Social Media is a useful tool further prove connections.

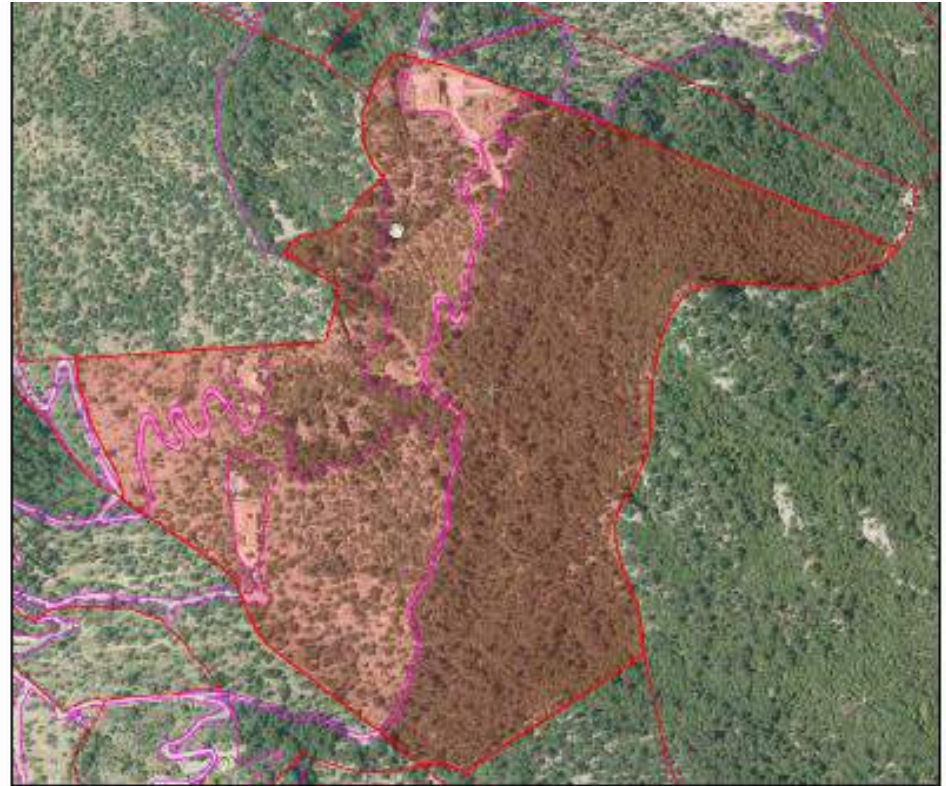


Social Media Analytics

Beautiful day in #deia @
gets better



, just



Challenges in Forensic Audits in India

- Borrower does not give full information
- Borrower does not provide access to ERP
- Data on machines is destroyed
- All banks don't cooperate equally
 - All banks (including outside the consortium) should share statements
 - RBI can play a critical role
- Forensic Audit is on a company – not on the group or related party
 - Unable to conclude
- Forensic Audit starts very very late

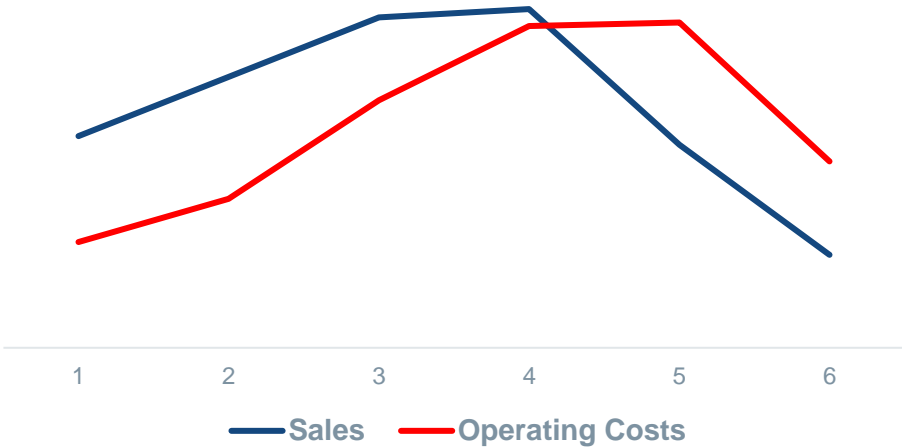
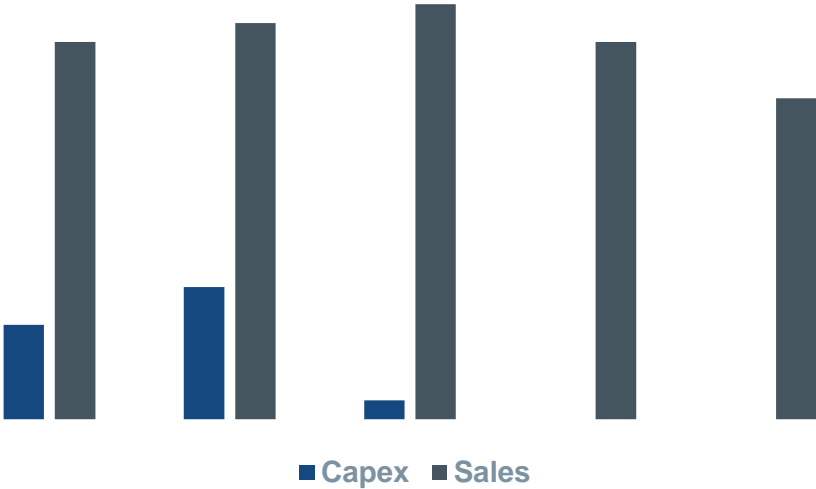
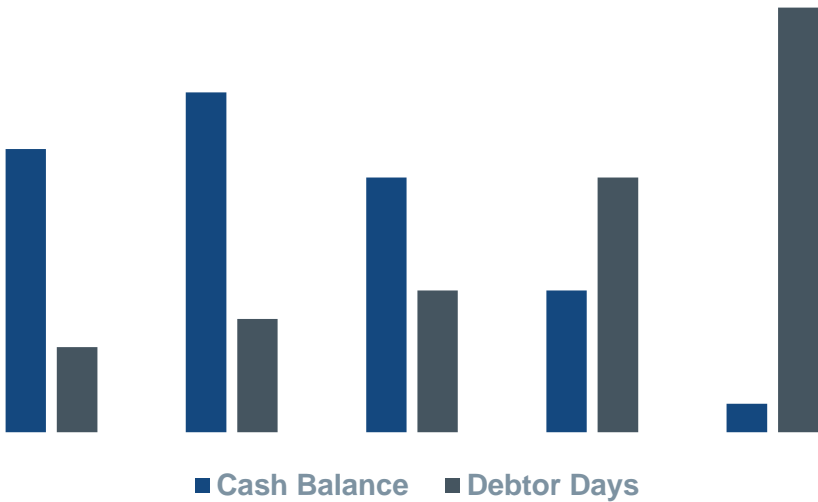
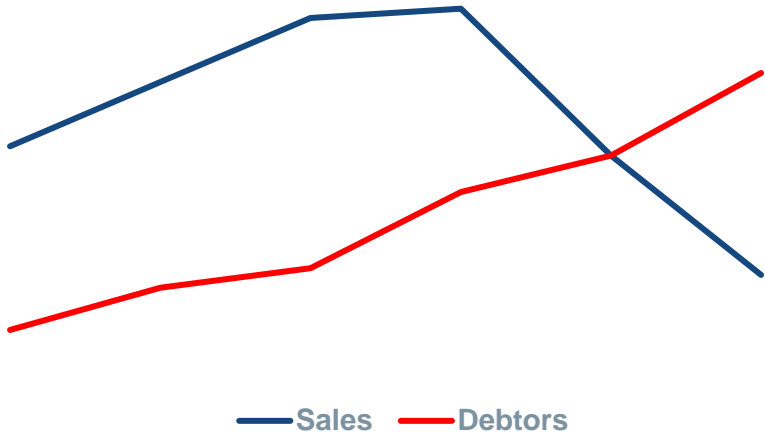


04

How to pre-empt
frauds

Financial investigation

Unexpected surprises in otherwise well functioning accounts



Questions you should ask

- **When and where was the business setup?**
 - Offshore jurisdictions can be used for tax optimisation or to place a veil of secrecy difficult to pierce should things turn sour
 - Also, recent incorporations seeking large loans are a red flag by default
- **In which countries do they operate?**
 - Get evidence of shipments/ letter of credits from third parties to prove that products were delivered/shipped
- **Who are the stakeholders, shareholders and directors?**
 - Ultimate ownership can be different from disclosed ownership
 - Do they have internet and media presence? Are they known?
- **Do they have audited financial statements?**
 - Who are the audit firms? How often do they change?
 - Are they Going concerns?
- **Read the Chairman's letter in the published financial statement**
 - They are often very informative as to where the company is going
- **Review the website. Does it look updated? are they keeping up with news? does it look sophisticated compared to the declared revenue and results?**

Questions you should ask

- **Does the growth/profit reflect the industry's trend? Are the underlying business plans presented to the bank in line with the market trend? Are these plans reasonable and feasible?**
- **Compare growth year on year (horizontal vs vertical analysis of Revenues, Costs, etc.).**
 - Unusual spikes might be normal course of business (I.e. hotels are subjects to holiday seasons). Equally, flat and growing charts might show revenue/cost smoothing that might suggest accounting gimmicks.
- **Compare revenue/costs vs FTEs year on year.**
 - Companies tend to hide their true FTEs with the employment of temp workers. Whilst the use of temp people might be good to face spikes in demand, it might also be a red flag
- **What is the expenditure for marketing and consulting costs?**
 - Low marketing costs and high revenues might be a red-flag. Also, high level of consulting costs might be an indicator of diversion of funds

Questions you should ask

- **Review top 10-50 Customers and analyse trend year-on-year.**
 - Oftentimes, before applying for loans and capital injection, customers' orders show a double-digit upward trend that might suggest channel stuffing or early revenue recognition
- **What sort of incoterms do they use for shipments? Are these in line with competitors?**
 - Series of pre-defined commercial terms published by the International Chamber of Commerce that are widely used in International commercial transactions or Procurement
 - At times, to entice clients to buy shipments and increase revenues, incoterms might be used as form of discounts
- **What is the level of credit notes issued to clients in the last 3-5 years?**
 - Credit notes can be used to offset receivables generated in previous years.
- **What is the level of fixed assets? are all depreciated? where are they based? owned or leased? who owns the land? and the lease?**
- **What is the level of receivables write-offs**

Things to remember

- Fraud is a habit – it is not one-off
- There are signs – need to have an eye for them
- Question anything unusual – don't assume
- There is no small fraud and bid fraud – it's fraud
- Always ask the suspect upfront – the response suggests next steps
- Prevention better than cure – do the homework before not afterwards
- Seek external help – specialist look at the situation very differently