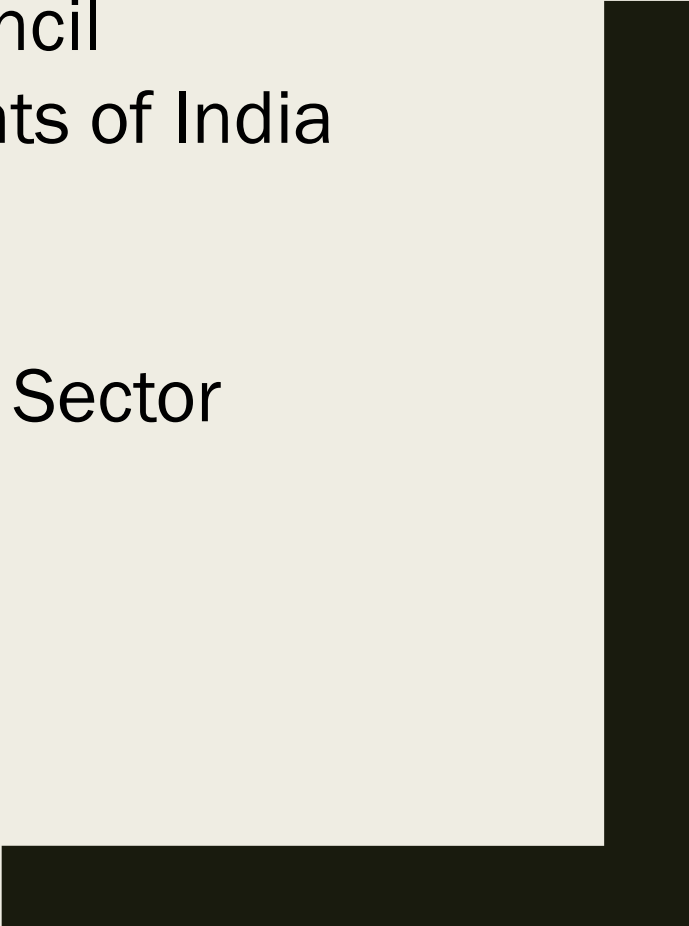




J B Nagar CPE Study Circle
Western Indian Regional Council
The Institute of Chartered Accountants of India

Early Signals of Fraud in Banking Sector

CA Vikas Jhunjhunwala
March 16, 2018

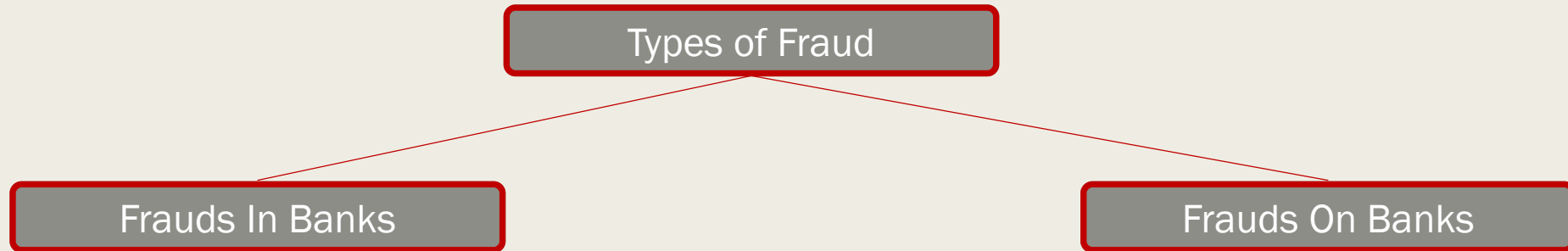


INTRODUCTION

- ✓ Master Direction on Fraud dated 1st July 2016 by RBI.
- ✓ Early Warning Signals of Fraud as per ICAI



Definition: RBI working group on **Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds** has defined Fraud as “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.”



- ✓ Cash lending during working hours
- ✓ Missing notes in bundles
- ✓ Use of same note bundles by two branches
- ✓ Posting in wrong accounts
- ✓ Misuse of sensitive stationery

- ✓ **Technology** – Malware attacks, phishing, vishing, SMSishing, whaling, card duplication etc.
- ✓ **Deposit** – Misuse of Inoperative Ac, Non reco. of suspense / sundry Ac, Lack of KYC compliance etc.
- ✓ **Advances Portfolio** – Deficient appraisals system, poor post disbursement supervision, inadequate follow up etc.

Early Warning Signals of Fraud

Total 43 items

Operation of Account

- Bouncing of high value of cheques
- Frequent invocation of BGs and devolvement of LCs
- Frequent request for general purpose loans
- Frequent adhoc sanctions, etc.

Concealment of Docs.

- Substantial increase in unbilled revenue year after year
- Poor disclosure of materially adverse information
- Material discrepancies in annual report, etc.

Diversion of Funds

- Non-routing of sales proceeds through consortium banks
- High value RTGS payment to unrelated parties
- increase in borrowings despite huge cash equivalents in the balance sheets, etc.

Issues in Security

- Critical issues highlighted in the stock audit report
- Significant movements in inventory and receivables disproportionately differing vis-à-vis change in the turnover, etc.

Inter Group Transaction

- Funds coming from other banks to liquidate the outstanding loan amount
- Substantial related party transactions with inter-connected companies and large outstanding from such companies, etc.

Regulatory Concern

- Default in undisputed payment to the statutory bodies, raid by Tax Authorities.

Other

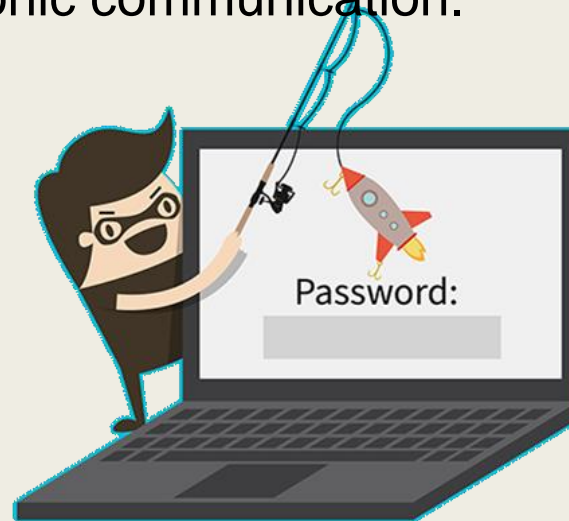
- Resignation of key personnel and frequent changes in Management
- Significant reduction in stake of promoters, etc.

Fraud vs Information Technology (IT)



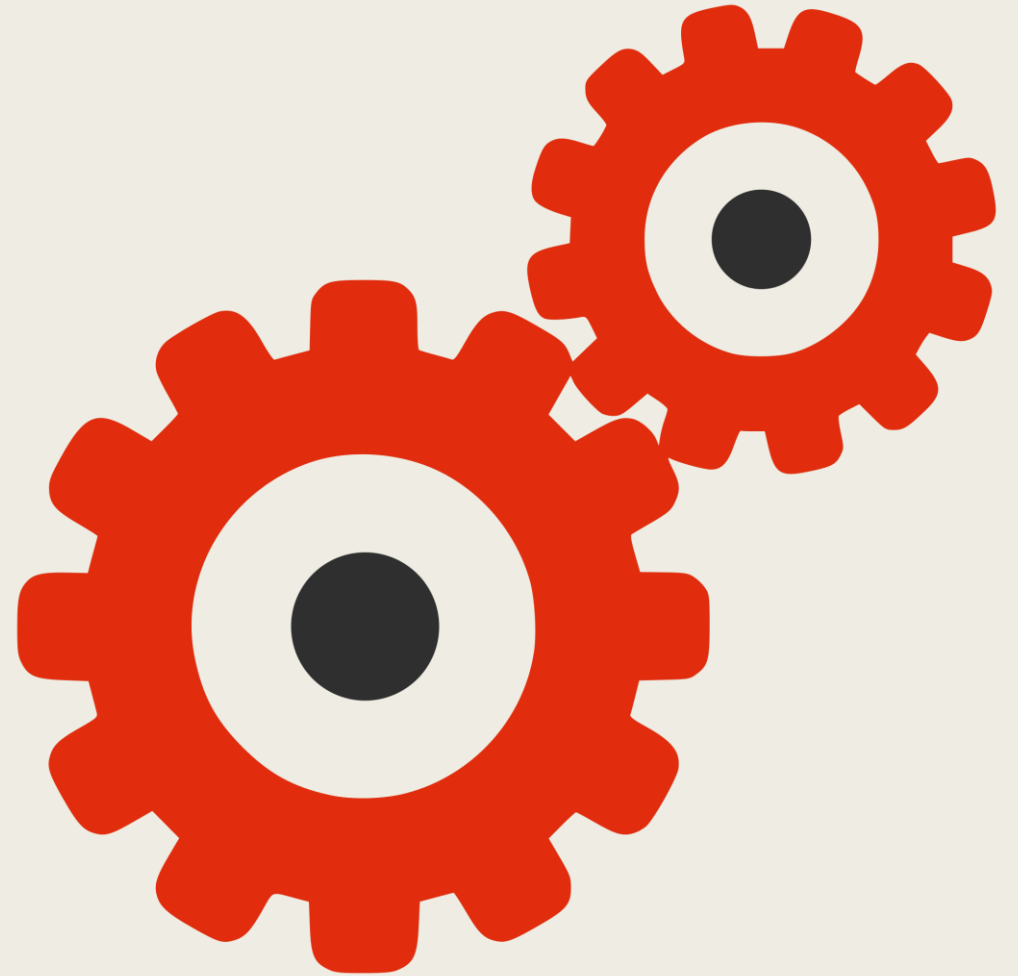
Phishing

Refers to the acquiring of sensitive information such as user names, passwords or credit card details by masquerading as a trustworthy entity in an electronic communication.



Section 1

Operations of Account



Bouncing of High Value Cheques

S1

Modus Operandi

Deposit of High Value cheques

(to bring down the o/s with sanctioned limit)

Outstation or Co operative bank cheque are used

(time lag in clearance and system treats the account as regular and does not flag as NPA)

After some time cheque bounces and reversed by system

(Treated as regular withdrawal by system and not considered back dated)

- ✓ Cheques of the same party from different bank accounts or cheques from associates or related parties are used for such mischievous transactions for window-dressing the account.

Bank's Control – Prevention / Detection

- ✓ CBS system can identify and red flag such transactions and give an exception report.
- ✓ Based on above, restrict withdrawals from the account against such deposits
- ✓ Borrower may be warned by sending letters
- ✓ Staff may be assigned to monitor the account on constant basis.

Audit Process

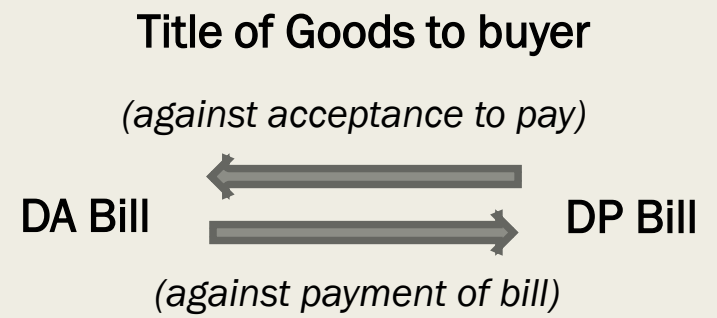
- ✓ Check the exception report (daily, fortnightly or monthly basis) and identify such accounts.
- ✓ Ascertain whether the Branch is allowing the borrower to withdraw funds against such deposits.
- ✓ Ascertain deposits are not used to mislead the system in missing out flagging the account as NPA.
- ✓ Repetition of same account and such window dressed transaction may be red flagged or reported.

Foreign bills remaining outstanding with the bank for a long time and tendency for bills to remain overdue

S2



- **Pre Shipment Credit** – Exporter take PSC to process, procure and manufacture goods.
- **Post Shipment** – Exporter to bank – for the credit period involved in receipt of payment.
- Bill of Exchange is drawn by Exporter (drawer) on buyer (drawee) and beneficiary is Exporter’s Bank.



At the most basic level
Invoiced quantity, value or quality of goods **≠** Actual quantity, value or quality of goods

Other Factors – Business Related

- Goods not in line with the contracted PO – delivery schedule, quality etc.
- Inadequacy of Certificate of Origin.

Proper follow up from bank is required

Other Factor – Non Business Related

- Nexus / Unhealthy tie up between Exporter and Buyer.
- Under / Over / Multiple Invoicing of same shipment.
- Falsification of description / quantity of goods.

Credit report from International Agencies are relevant. Exporter to be encouraged for ECGC cover

Foreign bills remaining outstanding with the bank for a long time and tendency for bills to remain overdue

S2

Bank's Control – Prevention / Detection

- ✓ Export should be informed to **Director General of Foreign Trade (DGFT)**.
- ✓ Declaration of value or expected value should be available in form **GR, PP or Softex Form**.
- ✓ Time Limit for realization – **15 months** in case of export to outside warehouse otherwise **9 months**.
- ✓ Payment should be received through AD Bank in manner as specified in Foreign Exchange Management Regulation, 2016.
- ✓ Bank should maintain Export Bill register and same to be monitored and updated regularly.

Details of outstanding bills can be obtained from **EDPMS (Export data Processing and Monitoring System)**.

Audit Process – Check Points

Discretionary power of Branch Manager	Sanctioned Limit	ECGC Cover
Docs. to submitted within 21 days	Docs.to confirm to LC / Order	Informing of overdue to exporter
Adequate reporting to RBI	Docs. for title of goods are received	Insurance Cover
Reco. of Nostro & Vostro A/c	Manual bill verification - custom house	Verification of High Sea Sales Docs.
Multiple sub threshold breach	Immediate withdrawal from accounts	Third party remittance to be scrutinized
Overdue bill to be transferred to Overdue head	Steps taken for dishonored bills	Process of tallying of O/s balances

Delay observed in payment of outstanding dues

S3

DUES

Statutory Dues	Excise, VAT, GST, Service Tax, TDS, ESIC, PF etc.
Creditors	For goods / services received.
Others	Salary, Rent, Admin Expenses etc.

- ✓ Result in Penalty / Interest / Prosecution
- ✓ Liquidity Issue (Temporary / Chronic)
- ✓ Higher cost
- ✓ Operational problems
- ✓ Erosion of Liquidation Value

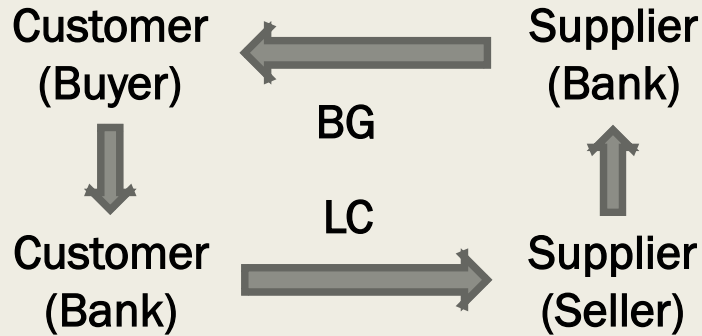
Case Study

Sanction Credit Limit	400 Cr.	Before renewing the limits the bank decided to inspect the books of the borrower. The inspection revealed that the turnover shown by the borrower was not genuine. The sales were inflated to substantiate the credit availed.
Service Revenue	1400 Cr.	
Service Tax paid	40 Cr.	
Other Information	Frequent raid at office	

Frequent devolvement of LCs & Invocation of BG's

S4

Letter of Credit (LC) / Bank
Guarantee (BG) – Non Fund Based



Risk Indicators

- ✓ Liquidity Crunch – Non Fund converted to Fund Based Limit
- ✓ Inadequate Security / Margin
- ✓ Parking of dues in a new account by banks.

Bank's Control

- | | |
|---|---|
| <ul style="list-style-type: none"> • Serial Numbered BG • 2 Authorised Signatories • Security Available • Customer Financial report • Under consortium – inform to lead bank • For performance BG – expertise of the customer to be accessed. | <ul style="list-style-type: none"> • Non fund to fund limit to be closely monitored and hypothecation of goods to take place. • Timely recording of transaction in books. • Immediate submission of custom's copy of BOE. • Measure defined by FED. |
|---|---|

Audit Process

- Timely recording of contingent liability.
- Opening of documents based on compliance of LC terms, shipping documents and compliance of Master Circular.
- No parking of fund in other account to overcome IRAC.
- Analysis of report of devolved / invoked LC / BG.
- Non fund based facility to other than existing customers.
- Upkeep of guarantee forms – stocking, reconciliation, proper custody etc.

Under or Over Insured Inventory

Inventory composition & Fraud Indicators



S5

Bank's Control

- Annual stock audit by external Auditor
- Periodic inspection by Bank
- Insurance cover
- Obtaining operational / financial data
- Proper calculation and recording of DP

Audit Process

- System / method of accounting, valuation, verification, adjustment and DP calculation.
- Ratio analysis, sudden movements, insurance cover, trend analysis and comparison.
- Physical Verification (if possible)



Invoices devoid of TAN and other details

S6

TAN

- ✓ 10 digit alphanumeric code
- ✓ Issued to person required to deduct / collect tax on payments made.
- ✓ Required by everyone, responsible for TDS or TCS.
- ✓ To quote this no. in all TDS returns, payments, certificates etc. with tax department.

- ✓ 15 digit alphanumeric code
- ✓ Required to be taken by assessee if turnover exceeds prescribed limits.
- ✓ Required to quote this no. in all GST returns, payments etc. with tax authorities.
- ✓ Invoice must consist of number, name, shipping and billing address, taxpayer's GSTIN, place of supply, HSN / SAC code etc.

GSTIN

Risk Factor

- Invoices devoid of PAN / TAN / GSTIN number raise doubts about the genuineness which in turn impacts the Drawing Power & the eligibility of the bank funding to the Borrower.
- May lead to no security or collateral for exposure.

Audit Procedure

- Bank internal control process and compliance thereof to be accessed.
- Major invoice may be checked in case of Invoice discounting facility.

Funding of Interest by sanctioning additional facilities

S7

Genuine funding under
restructured package

OR

Funding to retain the current
classification of account

Risk Indicator

- Incorrect Credit Appraisal – more credit than Maximum permissible Banking Finance.
- Inadequate security cover.
- Diversion of Funds – either earlier or newly sanctioned.
- Unviable Project.

Bank's Control

- Obtain additional security
- Additional monitoring
- Downgraded on non adherence of terms of restructuring
- Projection vis a vis actual result on continuous basis.

Audit Process

- Detailed study of appraisal note to verify the reason for stress on liquidity.
- Adherence to sanctioned terms.
- Proper authority channel.
- Obtain end use certificate for external CA.
- Verify regular monitoring.
- Verify operation of accounts for suspicious transaction / funds being siphoned.

Frequent Ad Hoc Sanctions / general purpose loans

S 8, 9

Ad Hoc or Temporary Limit

Ad-hoc limit is over and above the existing sanctioned limit granted to borrowers, sanctioned for contingency needs for;

- Sudden bulk order
- Proposal of the working capital is either in the process of enhancement or renewal
- Other case with suitable justification.

Bank's Control

- Adherence of time limit for Ad hoc sanctions – 3 months.
- Should be authorized by higher hierarchy.
- Obtain additional security.
- Close monitor of performance.

Risk Factor

- Non intended use of Funds
- Cost escalation over the planned budget leading to viability estimation.
- Inadequate security for Ad Hoc sanction.
- Frequency, implies poor judgment or management of working capital.

Audit Process

- Seasonal increase is supported by earlier audited years.
- Check the rationale considering the present industry trend.
- Limit is given as per credit policy followed by the bank.
- Verify the purpose in line with the request letter.
- Adequate security creation.
- End use certificate from external CA
- Regularization within time and history of the same.
- Time gap between adjustment and fresh sanction.

Heavy cash withdrawal in loan accounts

S10

Risk Indicator



Small amount
periodically



Large amount
occasionally

Audit Process

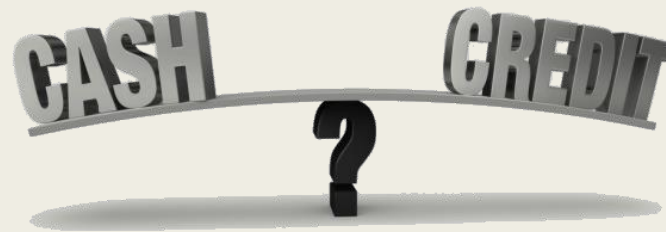
- Compare monthly average with previous year.
- Nature of transaction in the industry.
- Check transaction in accounts of related parties.
- Check business indicators eg. growth in sales etc. leading to additional working capital.
- Comment if no steps taken to reduce the same

Information Source

- Statement of Account
- CTR generated from CBS
- Daily cash scroll report
- Cash Book
- Exceptional Transaction report

Bank's Control

- Limit on cash withdrawal
- Prior permission
- Sanction in WC estimation
- System generated alert



Significant increase in working capital borrowing as percentage of turnover

S11

Risk Indicator

- Actual not in line with estimates.
- Change in industry trend, market scenario or economy.
- Substantial increase in debtors or stock not in line with sales etc.

Bank's Control

- Debit / Credit summation flag in system based on WC limit.
- Substantial decrease / increase in above should be adequately monitored.
- Frequent inspection and matching the transaction in account.

Audit Process

- Scrutinize the ledger, stock and receivable statements, annual audited reports, stock audit reports, unit inspection reports etc.
- Whether the funds have been diverted when the business has declined and the WC limits have been the same.
- **Nature of sales and quality of debtors**

Working Capital Borrowing Limit

- Based on CMA data
- Past audited and future estimated turnover

High t/o = High WC



Section 2

Concealment
or Falsification
of Documents

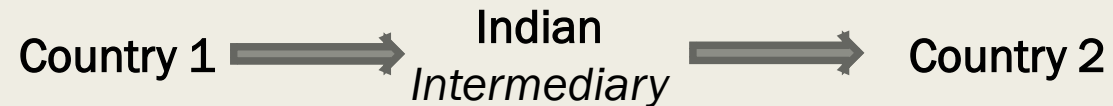


Fake

In Merchanting trade, import leg not revealed to the bank

S12

Merchant / Intermediary Trade



Component of Merchant Trade

- Should not enter the domestic tariff area
- Should not undergo any transformation
- Should be permitted for export / import under FTP.
- Both the legs of transaction to be routed through same AD bank.
- Transaction to be completed in 9 months. No outlay of Foreign Exchange beyond 4 months.
- AD bank to ensure one to one matching in case of each merchanting trade. Defaults to be reported periodically.

Risk Indicator

- Inadequate documents to support genuineness.
- Non adherence to KYC AML guidelines.
- Proper credit report not available.
- Getting payment on adhoc basis and not for each transaction.
- Export on credit basis whereas imports are based on LCs issued.
- Receipt against transaction from 3rd parties.
- Concentration of trade with few parties.
- Lower margin to trader or losses incurred.
- Movement of goods and name of intermediary not established

Concealment of certain vital documents like master agreement, insurance coverage

S13

Many times borrowers do not submit documents citing reasons like confidentiality, non-availability of concerned personnel, awaiting approval from partner, etc. Continuous deferring submission of these documents creates suspicion.

Risk Indicator

- Delay / Non submission of master agreement, insurance policy, stock statement, audited financials, additional documents (in case of real estate) etc.
- Avoidance of unit visit / stock audit
- Delay in documents for renewal.
- Insurance policy without bank clause.
- Non disclosure of arrangement with other banks.

Bank's Control

- Sanction to be stopped until receipt of necessary documents.
- Independent post disbursement monitoring cell to be made.
- Periodic review of documents.
- Periodic schedule for visits.
- Penal procedures to be adopted.

Audit Process

- Walk through of implemented processes
- Steps taken for tracking the non available documents.
- Timely updation of records and referring the same to document management cell.
- Procedure adopted for non receipt of documents, whether disbursement made or not.
- Review of concurrent and internal audit report.

Frequent change in Accounting period or Accounting Policies

S14

Undue favor to business



Change in Accounting Period / Policy



Requirement of law / better presentation

RISK FACTOR

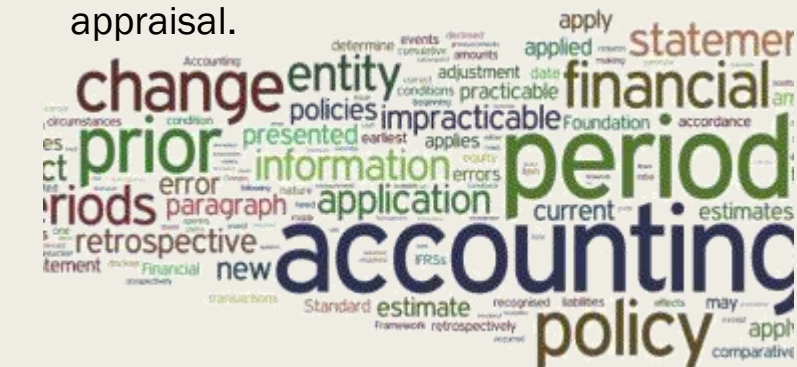
- Form over substance.
- Variance with industry norms.
- Generic policies given.
- Deferring of items.
- Unusual policies eg. Booking of revenue on shipping instead on transfer of risk or reward.
- Results too good to be true.
- Comments by auditors.
- T/O in books vs operating a/c
- Not able to demonstrate reason for change.
- Ind AS – significant impact on reserves, Fair Value estimate.

Control

- Expert team to review financials and call for required justification.
- Strong internal rating procedure.
- Industry expert opinion.
- Actual vs projection variance analysis.
- Close monitoring for change on adoption of IndAS.



- Check Inadequate disclosure of policies.
- Independent review of financials.
- Concerns raised in bank's internal or external review properly satisfied.
- Change in policy / period not in line with industry.
- Impact of change considered in appraisal.



Claim not acknowledged as debt

S15



Contingent Liability

- ✓ May Crystalize
- X May Not Crystalize

Accounting Treatment

- ✓ Disclosed in Notes to Accounts
- X Not Provided For

Higher contingent liability may mean high risk and may adversely effect the financial position of the company. Don't ignore just because it is off Balance sheet item.

Control

Call for explanation for all contingent liabilities including claims against company not acknowledged as debt.



Bank has considered contingent liabilities while appraising and has obtained justification from the borrower.

A Contingent Liability



Substantial increase in unbilled revenue year after year

S16

Recognized



Unbilled Revenue

Not Billed to Purchaser



Real Asset



Imagined Asset

Risk Factors

- Constant rise in unbilled revenue with no new contract or arrangement.
- Unbilled revenue grows faster than sales or billed revenue.
- No cash flows while reporting earning growth
- Non movement in stock but increase in receivables
- No routing of sales through bank
- Long o/s unbilled revenue.

- ✓ **Timing Difference** – difference in processing of time sheet vis a vis invoice.
- ✓ **Rate Variances** – eg. actual indirect rate differ from provision / target rate etc.
- ✓ **Cost in excess of billings** – eg. billing are less than the revenue that can be recognized to date etc.

Bank's Control

- Check for ageing of unbilled revenue
- Actual cash flow vs revenue
- Justification for sudden increase
- 3rd party receivable audit
- Direct balance confirmation
- Ageing of receivables vs turnover
- Forensic audit

Audit Process

- Existence of adequate basis of unbilled revenue.
- Review of stock and debtor statement with audited numbers.
- Review of related party transactions.
- Tracing of receivables in operating a/c vs receivables
- Turnaround time from unbilled to billed.

Material discrepancies in Annual Report / significant inconsistencies within the report

S17, 18

The Divergence or discrepancy is broadly considered as differences between facts and claims or omission of certain required details.



Risk Indicator

- Delayed submission of AR
- Unsigned copy of AR
- Non disclosure of required details in AR
- Using improper format
- Change in date of closure of annual accounts.
- Difference between stock statement vis a vis AR.

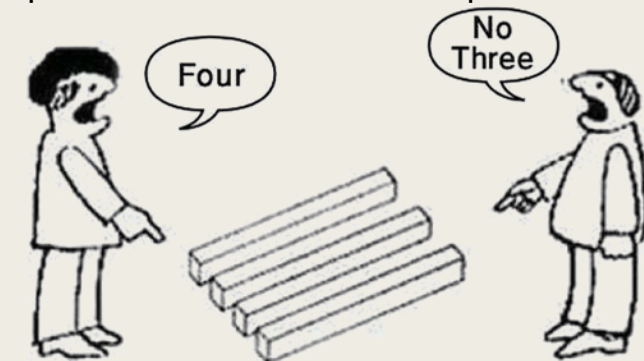


- ✓ Disclosures in variance with requirements.
- ✓ Capex from short term funds.
- ✓ No breakup of manufacturing / trading sales.
- ✓ Increase in sales not in line with increase in cost.
- ✓ Incorrect classification of long term and short term balances.
- ✓ Security as per bank sanction and AR differs.
- ✓ Comparison on data in director's report vs AR.
- ✓ Method of valuation – statement vs AR



Control

- Track due date of receipt of AR with actual date of receipt.
- Analyze cases where date of AR has been changed.
- Comparison of key data as per AR with yearly submissions.
- Expert's review of Annual Report.



Poor disclosure of materially adverse information and no qualification by the Statutory Auditors

S19



Prescribes the Format of the Financial Statement & disclosures required to be given.



Disclosure by Auditors in line with Auditing Standards



Risk factor

- Non Disclosure of Related Party transaction, discontinuation of operations, share encumbrance, security given for borrowings etc.
- Ambiguous / inconsistent accounting policies.
- Disclosure for default in loan vis a vis terms.
- Disclosure not in line with peers.
- Incorrect classification of activity in cash flow.

Bank's Control

- Continuous training to staff for amendments in standards and policies applicable to industry.
- Develop a process to obtain Financials directly from auditor.
- Gather information of auditors through internet, ICAI website and other sources.

Audit Process

- Understand the process of receipt and analysis of audited financial statements.
- Study disclosure of peers and compare with the disclosure of borrower.
- Compare areas of business of borrower and segment reporting.
- Cash flow analysis vis-à-vis financial statements.

Poor disclosure of materially adverse information and no qualification by the Statutory Auditors

S19



- Review of bank statement revealed that XYZ Ltd., a borrower of the bank has transferred funds of Rs. 500 millions to a Director of the company but the same has not been disclosed in Financial Statements and not reported by the Auditor of the borrower in Audit Report.
- Review of Directors' Report mentions that due to technological improvements, the company needs to replace major part of its machinery. However, the company calculated depreciation at normal rates instead of increased rate due to obsolescence of current machinery and the same has not been reported by the auditor.

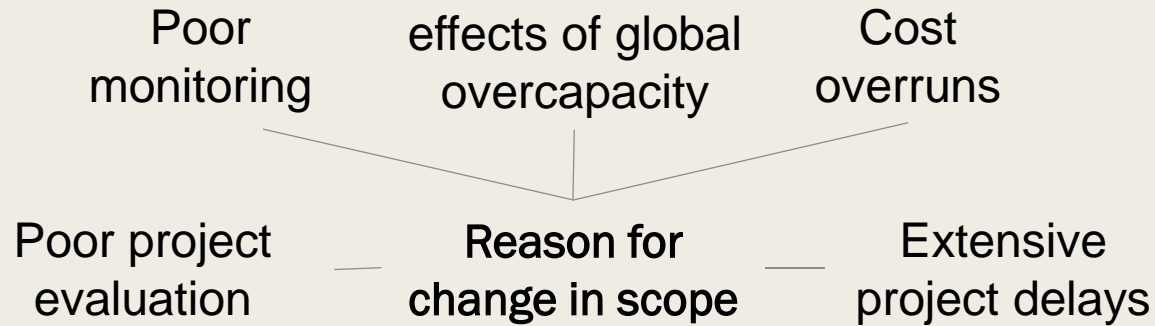
Section 3

Diversion of Funds



Frequent change in the scope of the project to be undertaken by the borrower

S20



Source of Information

- Audited end use certificate
- Periodic project status
- TEV study report
- Joint Lender / Consortium Meeting Minutes

Risk Factors

- Lack of significant progress with no apparent road block
- Transfer of funds as investment not related to project
- Increased non budgeted expenses
- Disputes with vendors / service providers
- Caveats in TEV study
- PO for machinery from unknown parties instead from OEM.

Bank's Control

- Ensure independence of Risk Team of the project
- Conducting independent TEV studies
- Control on breach of covenants
- Change in scope vs cost required vs sanction
- Equity vs debt requirement
- Checklist for RBI guidelines.
- Utilization of funds already disbursed

Audit Process

- Verify bank's assessment of viability of the project.
- Detail study of TEV reports and caveats therein
- Change in scope is backed by regulatory clearances.
- Actual performance vs LIE report
- RBI compliance wrt to change in scope.

Sales proceeds are not routed through consortium / member bank/ lender bank

S21



- Routing of funds through other channels.
- Arrangement with other bank not disclosed to lead banker / consortium.
- Sales have gone down or not happening for one or the other reason.
- Liquidity crunch.
- Business being done in cash not recorded in Books to avoid taxation & other issues.



- ✓ Review the reason for the same. Check genuineness
- ✓ Call for justification.
- ✓ Check for tampering with securities pledged / hypothecated to the bank.

High value RTGS payment to unrelated parties

S22



- Funding Satellite Entities / Shell companies
- Round Tripping
- Short term overdraft to repay then overdraft paid by fresh sanctions
- Sale / sale of assets within groups inflated

Risk Indicators

- Bypass bank controls for transfer of funds.
- No genuine business transaction.
- Creditability of transferee.
- No supporting document
- Transfer to fictitious party
- Large commission for service
- Purchase from intermediaries other than OEM
- Quid pro quo arrangements

Bank's Control

- Suspicious transaction report to be reviewed on live basis.
- For Asset Quality Review, transactions should be reviewed by the bank's risk team.
- Threshold for trigger for no. of transaction, location, value etc.
- Scrutinize end use certificate with account statement.

Case Study

ABC Ltd. borrowed funds for a project. As and when there was disbursal in the account, ABC Ltd. used to make payment to the suppliers as per the confirmation received by the bank.

However, on scrutiny, there was huge amount transferred to an unrelated entity as commission for purchase of equipment for which there was no agreement in place by the borrower.

Increase in borrowings, despite huge cash and cash equivalents in Borrower's balance sheet

S23



Mr. X's business firm has cash & cash equivalent worth Rs. 100 Lakhs. Mr. X approaches 'Y' Bank for a Business Development Loan of Rs. 50 Lakhs @ lending rate of @ 12% p.a. Is there any ulterior motive of defaulting on repayment of loan ?

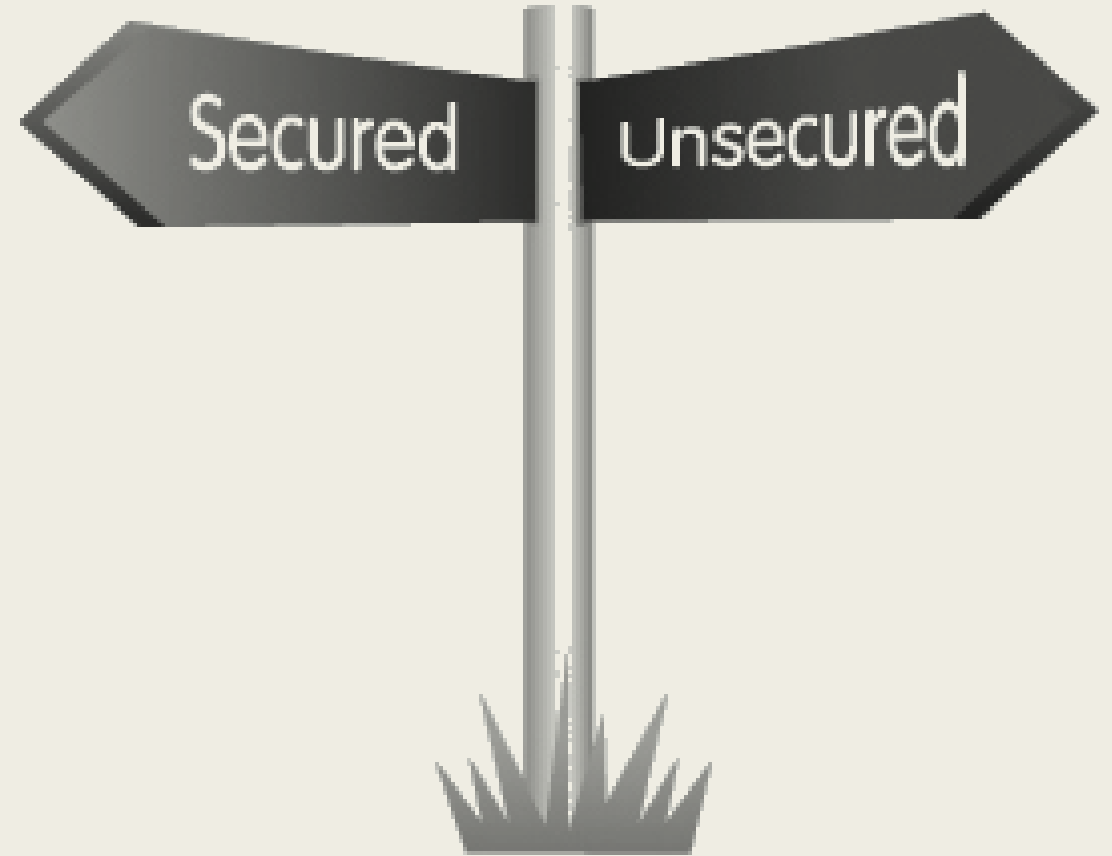
Such one off request to be reviewed for

- Inability of the borrower to effectively plan his borrowing and cash flow requirements
- Fictitious Cash & Bank balances
- Some other hidden covenants to cash and cash equivalents.
- Unusual pattern in balance for cash equivalents.

The company has borrowed money and put in bank fixed deposits pending usage of the same. The project was stalled due to regulatory issues. However, the borrowing and fixed deposits continued. Whether a borrower shall practically do the same.

Section 4

Issues in Primary / Collateral Security



Dispute on Title of Collateral Security / Exclusive collateral charged to a number of lenders without NOC of existing charge holders

S24, 25



Risk Indicator

- The title of the property may not be in the name of the borrower only and adequate documentation is not taken on record w.r.t. the consent of the holder.
- The search and title clearance report of the property is not obtained or some defect are specified in the Report
- Absence of availability of latest valuation Report of the (movable or immovable) property
- Exclusive collateral charged to a number of lenders without NOC of existing charge holders

Case1

ABC Ltd. had applied for a TL of Rs. 4 crores and had offered a collateral security owned by HUF wherein one of the directors of the company is Karta. Since the property is owned by HUF, even if the director is a Karta of the HUF, the property owned by HUF cannot be offered as collateral security to bank unless the **NoC of all co-parceners of HUF is obtained.**

Case 2

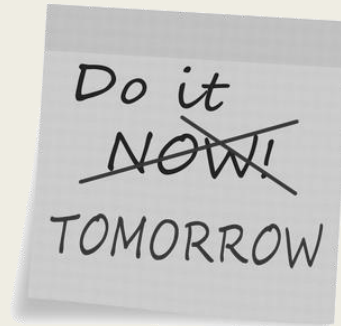
Mr. X had applied for a TL of Rs. 50 lakhs and had offered a **collateral security owned by private limited** company wherein he is a director.

As per Section **185 and 186**, *a property owned by a private limited company cannot be offered as a collateral security for the purpose of any loan obtained by its directors.* Thus, the charge on collateral security created by the financier (bank) would be void in nature.

Request received from the borrower to postpone the inspection of the godown for flimsy reasons.

S26

Periodic review of securities obtained under credit facilities, godown or factory is under by Bank directly or through 3rd person.



Some cases there are requests to delay / cancel the physical visit by bank officials or auditors on flimsy grounds may be to prevent / delay / cancel the visit by Branch Officials / Stock Auditors.

Reasons normally cited by the borrower

- No electricity
- Concerned staff on holiday
- Staff busy with other work
- Water seepage in factory
- Ongoing Renovation work at godown

In case of repeated deferral requests



Independently review the veracity of reasons / situations

Audit Check

- Review the cases wherein the site visits / stock audits have not been carried out at prescribed interval.
- Review communication with borrower.
- Whether delay also observed in other fillings by company or operations thereof.

Critical issues highlighted in the stock audit report / Charges appearing in ROC search report, not reported by the borrower in its annual report

S27/28

Few Critical issues

- Inclusion of **expired stock in the amount of stock** thereby inflating the value of inventory.
- Inventory not valued as per the Accounting Standard notified.
- Significant **difference** in amount and ageing of receivables as **per monthly stock statement** and as per **verification by Stock Auditor**
- Incremental change in receivables is significantly higher than the incremental change in amount of sales.
- Maintenance of **two separate ledgers** for a party (both sales and purchase). In case of ledger opened under debtor, the same only is included in Stock Statement and not the ledger opened under creditor.
- Considerable deviation (and not supported by proper justification for deviation) between the amount of Stock as per Stock Statement submitted to the Bank for the month of March and audited accounts.
- Part of fixed asset is considered under stock of spares / consumables / raw materials at the time of submission of Stock Statement.
- Liabilities appearing in ROC search report, not reported by the borrower in its annual report

Non-production of original bills for verification upon request

S29

ABC Ltd. had applied for a **TL Rs. 5 crores** for procurement of machinery of **Rs. 7.50 crores** from supplier. ABC Ltd. had **deposited own contribution of Rs. 2.50 crores** and the **bank made a remittance of Rs. 7.50 crores** to supplier by RTGS **against the proforma invoice**. Subsequent to remittance, the borrower **did not submit the invoice** under pretext that the remittance was made by RTGS and was against the proforma invoice submitted.

Proforma Invoice

quotation



Mr. ABC had applied for a vehicle loan for purchase of four-wheeler.

Had submitted a quotation from the vehicle dealer.

The bank had released the payment against Vehicle Loan to dealer.

However, the borrower had not submitted the original invoice for purchase of vehicle.

Significant movements in inventory, receivables disproportionately differing from change in the turnover

S30,31

Case 1

Particulars	Particulars
Customer	Manufacturer
Production Cycle (PC)	3 to 4 days
Facility availed	WC finance against stock and book debt.
Annual Turnover	Rs. 50 Cr.
Profit Margin	25%
To be WIP	0.30 to 0.40 Cr.
WIP as per stock statement	2 to 2.5 Cr. i.e PC of 19 days
Clarification to be sought for same.	

Case 2

A trading concern has given following details in stock statement. Profit margin is 10%.

Particulars	Stock	Book Debts	Trade Creditors
Opening	100	150	80
(+) Additions	30	54	10
(-) Deduction	40	94	50
Closing	90	110	40

Anomaly

- ✓ Addition in book debt should be 44 instead of 54 (other than taxes).
- ✓ Though the stock is increased by 30, creditors has increased by 10 only.

Increase in Fixed Assets, without corresponding increase in long term sources (when project is implemented)

S32



Compare statements of the past two years. If an organization fails to raise long term funds for fixed assets and uses short term funds for long term purposes there are chances of financial failure.

- ✓ Funding information should be obtained when such projects are under implementation for each asset being acquired / built.
- ✓ Ensure no working capital should be used for assets being created.
- ✓ Periodic monitoring to be carried based on reports / statements submitted and other available information.

Costing of the project which is greatly at variance with standard cost of installation of the project

S33

Fraud Possibility

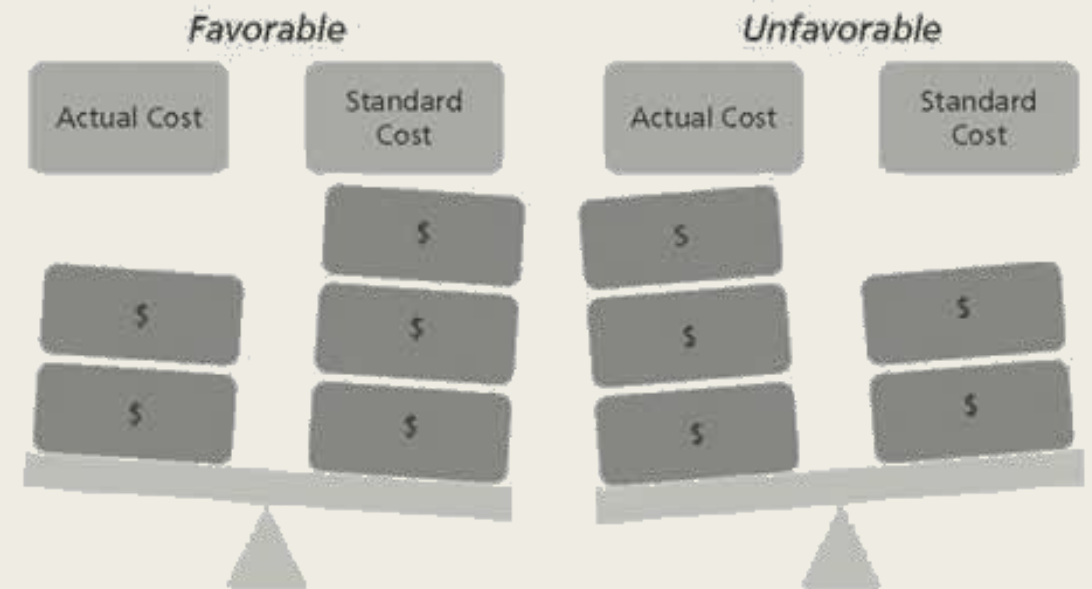
- ✓ Possibility of fraud when projected cost is much higher than actual as borrower would inflate the cost and manipulate it to take out his contribution as he may not have his own funds to invest in projects.

Outcome

- ✓ Project may become non viable.
- ✓ Break evens are high.
- ✓ Project might not able to start operation.

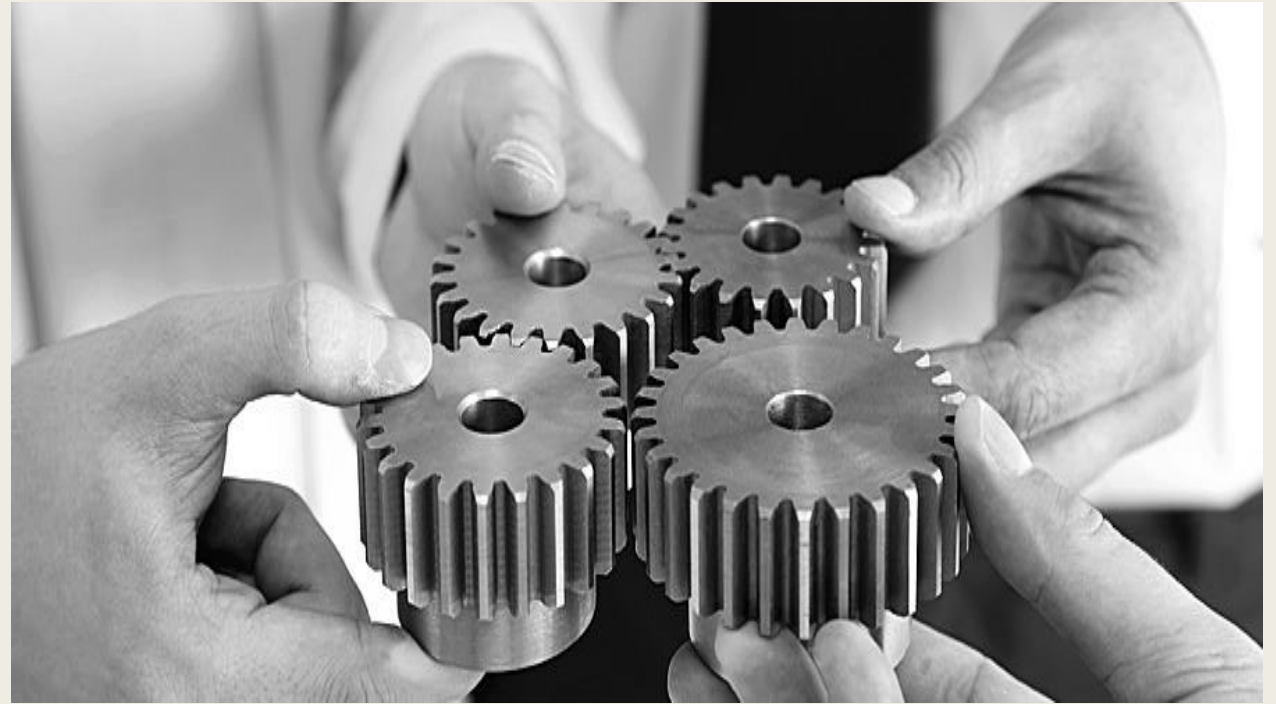
Reason

- Error / Omission in Estimate of cost
- Increase in price of Material
- Time Overrun



Section 5

Inter Group / Concentration of Transactions



Funds coming from other banks to liquidate the outstanding loan amount except in normal course

Floating front / associate companies by investing borrowed money

S34, 35

Questionable circumstances

Funds received from the other bank accounts requiring detailed scrutiny

- Account is about to slip in NPA / probable NPA.
- Funds are received through Cheque / Bill Purchase near the reporting date.
- Funds are received from a non-customer / non-promoter from other bank through other bank.
- Funds received through sanction of new loan from some other bank.

Case Study

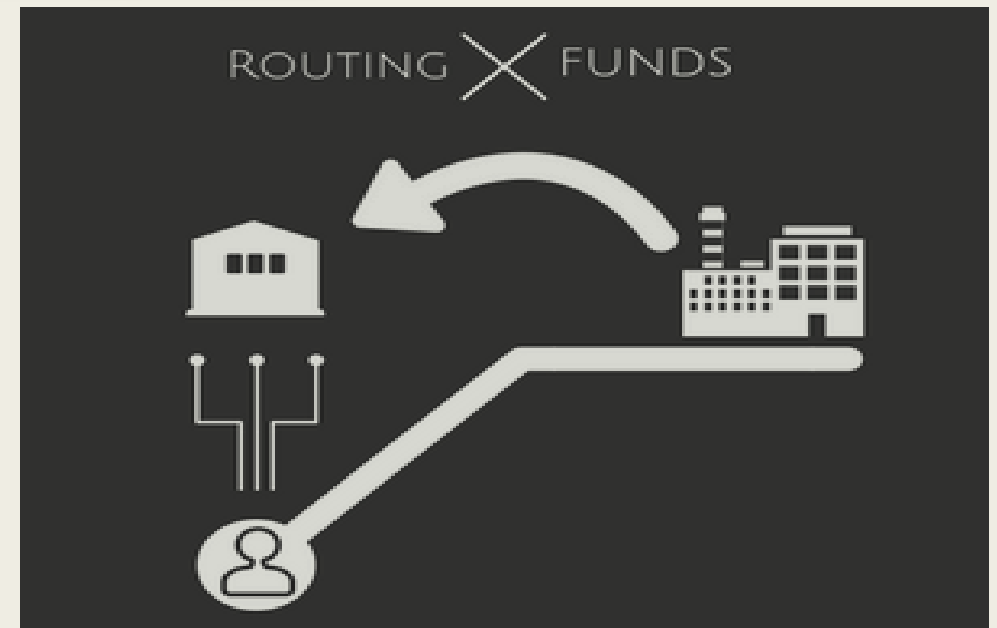
The company A limited has given interest free advances to its subsidiary amounting to Rs. 100 lakhs.

The bank needs to call for an explanation for giving interest free advances.



OR

Irregular Account

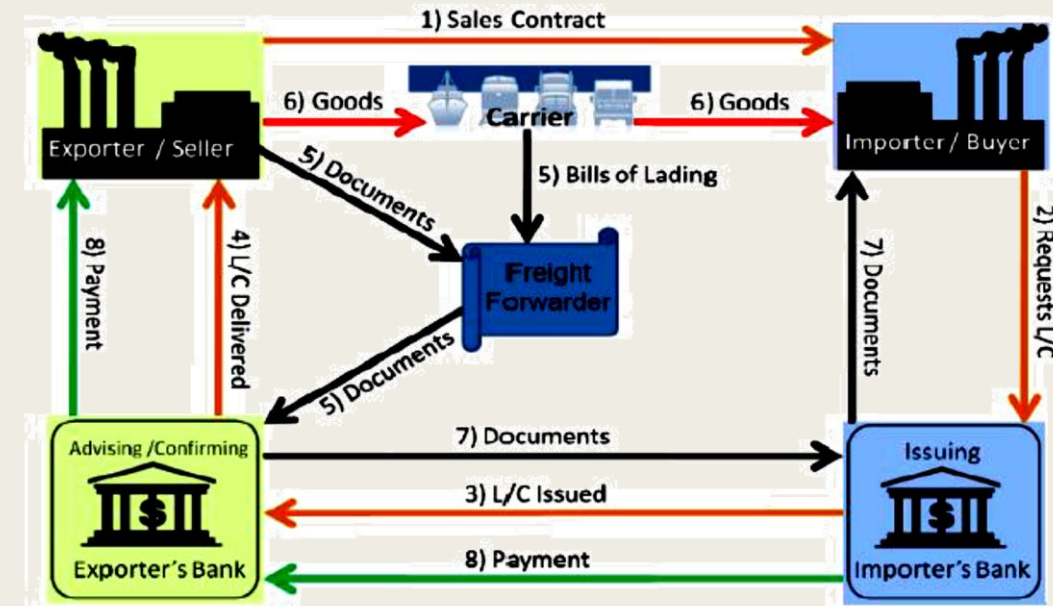


LCs issued for local trade / related party transactions without underlying trade transaction

S36

Risk Factors

- LCs issued in favour of seller, whose name is not appearing in the list of suppliers.
- Buyer and seller have warehouses/ factories in the same area.
- Lower transportation expenses.
- Transportation of goods is done through local transporters and not through IBA approved transporter.
- The consideration amount in transactions is exorbitantly high as compared to peers.
- The frequency of issuance of LCs and working capital cycle assessed at the time of appraisal does not match.
- No underlying transaction for LC.



Bank's Control

- Due diligence for assessing authenticity of the transaction
- LC limit to have approval for competent authority.
- Bank discounts bills under LCs based on sanctioned limits and not adhoc basis.
- The end use of funds disbursed through bills discounting under LCs are monitored closely

Audit Process

- Understanding tracking process for LCs issued vis-à-vis the size of business of the customer
- Understanding monitoring process for LCs issued in favour of related parties.
- Access and other IT Controls assessment in respect of Structured Financial Messaging System (SFMS) application.

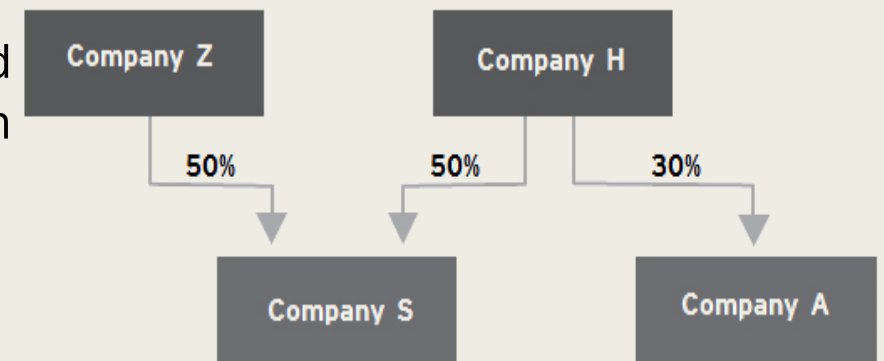
Large number of transactions with interconnected companies and large outstanding from such companies

Substantial Related Party transactions

S37, 38

Major Points to Look Into

- Transaction at Arm's Length Price
- Done for profit booking adjustments with intent to avoid taxes or to increase turnover so as to get benefits of higher working capital limits.
- Actual underlying transfer of goods & services in normal course of business.
- Quantum / trend of such transactions as a percentage to transactions with other parties.
- Transactions other than by way of Sales i.e way of fund transfers, say, lending / borrowing need to be seen from Funds Diversion perspective and inherent interest rate if any.
- Time lag in settlement of transaction.
- Evaluation of exposure at group level rather than entity level.



Section 6

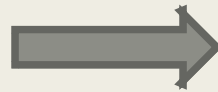
Regulatory Concerns



Default in undisputed payment to the statutory bodies as declared in the Annual report & Raid by Income tax, GST officials and others

S39, 40

- X Non Payment Statutory Dues
- X Non Compliance of regulatory requirements



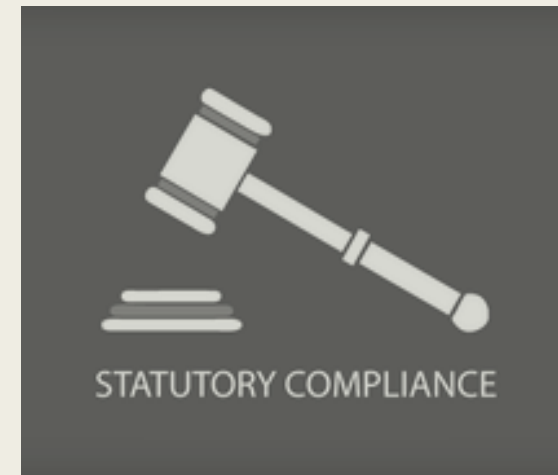
Impact working of borrower



Impact operation of Bank Account

• Case Study

- A borrower was enjoying credit limit of Rs. 100 crores. The turnover of the borrower as per audited financials was Rs. 400 crores.
- As per the stock audit report and newspaper reports there were raids on the premises of the borrower and the borrower accepted undisclosed income of Rs. 400 crores.
- It clearly indicated that the borrower had turnover which was not accounted and the accounts did not reveal the true picture of his business.



Section 7

Other Signals



Disproportionate change in other current assets

S41

Current Asset Comprises of
Cash / cash Equivalent
Stock in Trade
Account Receivables
Other Advances

changes to
→
*over a period of
working cycle*

Cash & Cash
Equivalent

Requires close
monitoring

Risk Factor

- Long pending advance to supplier.
- Advance to related party as trade advance.
- Spike jump in Stock in trade.
- Sudden increase in receivables. (fictitious sales)
- Increase in WIP. Process failure of defective goods.
- Increase in tax paid or fictitious tax credit.

Bank's Control

- Periodic review of financial report with submitted statement.
- Related party transaction to be justified.
- Age analysis of receivables / stock.
- Whether assets are getting converted in working cycle.
- Accrued claim of incentives vis a vis documents.
- Study of tax paid and tax demand.

Audit Process

- Banks adherence of process of collecting documents and periodic review
- Can interact with officer who had visited the site.
- Trend analysis and industry norms.
- Compare proposal, account statement and statement submitted to identify any fraud or weakness signal.

Resignation of the key personnel and frequent changes in the management

S42

Resignation may give following indication

- Deteriorating financial health
- Dispute in management wrt to line of business, manner of handling activities etc.
- Operational deficiencies.
- Onerous contracts may create liability on management.
- Reputation risk.
- Fraudulent transactions / diversion

Bank's Check

- Shareholding change should be monitored
- Any major transaction prior and post exit should be analyzed thoroughly.
- Periodic check from external sources.
- Background check of incoming management personnel.
- Status of personal guarantee given etc.

Audit check points

- Existence of personal security and effect of the same on sanction.
- Use commercial information to identify the reason for change in management.
- Desktop analysis of the industry, incoming or outgoing person.
- Check credibility of new key personnel joining
- **Change in auditors**



Significant reduction in the stake of promoter or Increase in the encumbered shares of promoter

S43

Check Points

- ✓ Analyze the reason / documents for change in holding whether due to issue of new capital or merger etc.
- ✓ Value of the security is not impacted adversely by any transaction which leads to reduction in promoters' stake.
- ✓ Analysis to done for sanctions given and other areas where change in holding can effect the working of the entity.

**CAUSE
FOR CONCERN**



Continuous reduction in promoter holding

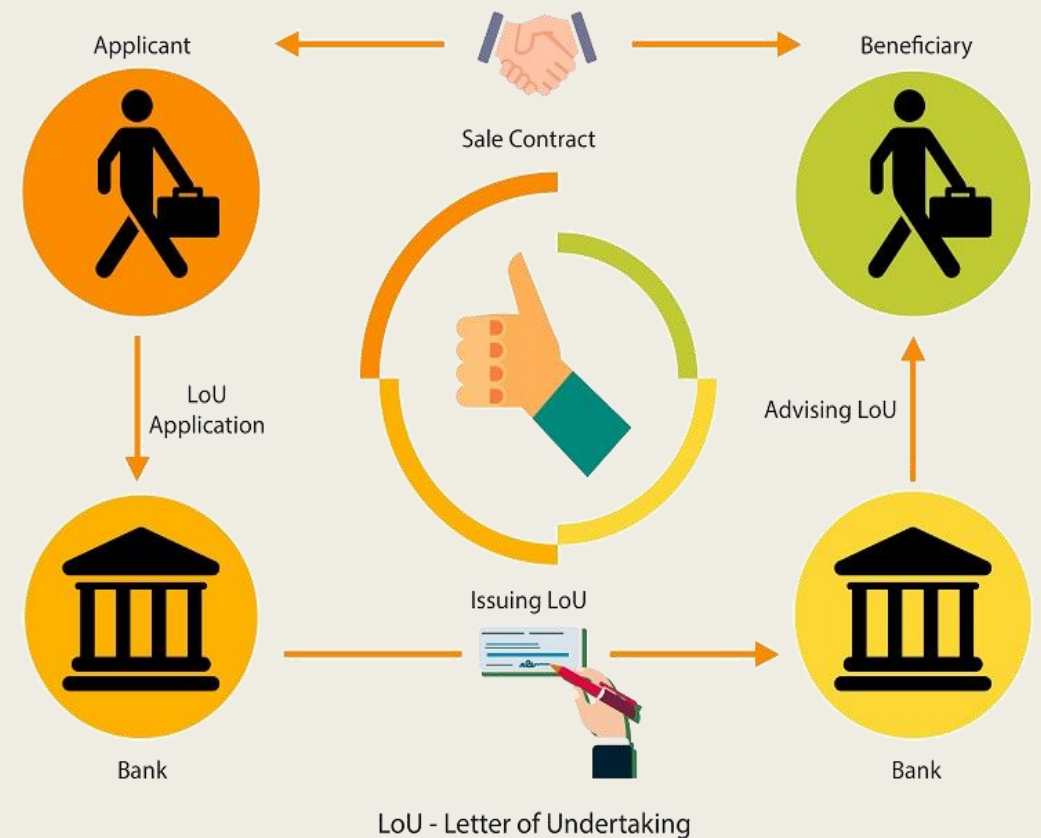
Encumbrances on shares of promoter



PNB Fiasco

Modus Operandi

- ✓ Borrowers management / executives came calling for a letter of undertaking, or LoU (essentially a bank guarantee against which another lender gives a foreign currency loan).
- ✓ From **SWIFT (Society for Worldwide Interbank Financial Telecommunication)** trail, one Junior level official fraudulently and without authorisation, issued LoU on behalf of some companies.
- ✓ The companies were maintaining only current account with the branch and none of the transactions were routed through Centralized Core Banking System.
- ✓ Based on LoU, the borrower raised money from another Indian bank's foreign branch in the form of a short-term credit to pay offshore suppliers in foreign currency. i.e the foreign bank remits funds to the NOSTRO account of the Indian bank, backed by the LoU. Thereafter, the Indian bank remits the funds to foreign supplier through its NOSTRO.



By rolling over of credit, borrower ensured that subsequent LoUs, repay the money due on the earlier LoUs. So, there had been no default until the new LOUs were stopped.

PNB Fiasco

Question to be answered or check point lapses

1. No control measure in system to prohibit junior level employee to issue such large LoU.
2. System not configured to use maker checker policy.
3. No collaterals taken prior to issuance of LoU.
4. Though the funds were released continuously without any entry in Books of accounts, why the same was not caught in the reconciliation carried by Treasury.
5. In spite of mandatory transfer policy, why the employees were not transferred after working continuously for 3 years in a branch.
6. How the same was unnoticed when there were various watchers.
7. Isn't there any process for periodic inter bank reconciliation between banks.



THANK YOU

Any Questions ...?

