

Early Signals of Fraud in Banking Sector



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Committee on Information Technology
The Institute of Chartered Accountants of India
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Foreword

It is a matter of immense pleasure for me to note that the Committee on Information Technology has come out with this enriching new publication on "*Early Signals of Fraud in Banking Sector*" which aims to provide a practical insight to the Internal Auditors, Statutory Auditors in identifying and detecting the early signals of fraud. This publication will help the auditors to trigger warnings in advance before the fraud actually occurs.

I am happy to note that the authors have made an earnest endeavor to share their vast experience and knowledge and their practical experiences have been explained in easy to understand language. This compilation of various early warning signals is expected to provide the requisite exposure to enable Chartered Accountants to get alerts and be cautious in cases of situations arising as detailed in this publication.

I am sure this compilation would be immensely useful for the Chartered Accountants, both in practice and Industry, to enhance the effectiveness and efficiency of their services and enable them to detect frauds before they actually occurs. It will help promote healthy environment for working professionals where any occurrence of fraud or related acts could be prevented well in advance so as to strengthen the trust of the society and people in general.

I complement CA. Atul Kumar Gupta, Chairman, CA. Jay Chhaira, Vice-Chairman and members of Committee on Information Technology of ICAI for initiating this publication and I am sure that this initiative would empower the members to augmenting their professional knowledge.

I compliment the Committee on Information Technology for this excellent initiative.

CA. Nilesh S. Vikamsey

President, ICAI

Preface

The Committee on Information Technology has great pleasure in releasing the new publication on “Early Signals of Fraud in Banking Sector” as a knowledge building initiative for members to help detect fraud ahead of time and prevent their occurrence.

In present environment the volume and gravity of instances of fraud across various sectors, particularly in the Banking sector, has gone up tremendously over the past few years. With the sweeping changes in the scope and magnitude of banking transactions witnessed in the past few decades, the emergence of hybrid financial products, the increasing trend of cross border financial transactions and the dynamics of real-time fund movement and transformation, the vulnerability of the system to the menace of fraud has become higher than ever before.

This publication is intended to equip the members with risk mitigation strategies i.e. to trace and detect signals of fraud beforehand so as to strengthen their grip on such incidents. It will provide an incisive analysis of how fraud occurs within the Banking Sector and explains the incidences which help create suspicion in the minds of the professionals in identifying early signals so as to prevent their materialization.

We would like to express our gratitude to CA. Nilesh Shivji Vikamsey, President ICAI and CA. Naveen N.D. Gupta, Vice President ICAI for their continuous support and encouragement to the initiatives of the Committee. We must also thank CA. Manu Agrawal, immediate Vice Chairman, Committee on Information Technology for taking this initiative forward, and all the present Committee Members. We also wish to place on record our gratitude for the co-opted members for providing their invaluable guidance and support to various initiatives of the Committee.

We would also like to extend our sincere thanks and appreciation to CA Srinivas Y. Joshi and other expert faculties, who contributed towards the technical material for this publication brought out by the Committee on Information Technology. We really appreciate their sincere efforts and dedication towards the work for the Committee.

We extend our heartiest congratulations to the Committee Secretariat and wish that the publication be a grand success.

CA. Atul Kumar Gupta
Chairman
IT Committee

CA. Jay Chhaira
Vice-Chairman,
IT Committee

Place: New Delhi

Date: July 17, 2017

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Introduction

Master Directions on Frauds Dated 1st July 2016

Reserve Bank of India, as a regulator of Banking Industry in India, has issued several Master Circulars and Master Directions which guide the banks on various aspects of banking. One such important guidance given by RBI is in case of Frauds in Banks. The Master Directions on Frauds dated. 1st July 2016 are issued to provide a framework regarding detection and timely reporting of frauds by banks to the regulator. It also requires banks to take timely action against fraudsters as well as the staff involved. The directions require banks to put in place measures by way of appropriate procedures and internal checks to prevent such occurrences in future.

RBI has not defined the meaning of term “Fraud” in its Master Directions. However, 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.”

There are two types of frauds possible in Banking Industry –

- (a) Frauds in Banks
- (b) Frauds on Banks

Frauds in Banks would include- 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, etc. These frauds are made by Bank’s Staff.

Frauds on Banks would include – Technology related Frauds, Deposit related Frauds, Advances Portfolio Frauds, etc.

Technology related Frauds– Greater Technology integration in Banks makes customer use platforms like Mobile, Internet and Social Media for enhancement of efficiency and cutting of costs. Online banking and transfers by NEFT and RTGS, use of ATM/Debit/Credit Card have become order of the day.

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The fraudsters employ hostile software programs or malware attacks, phishing (mails), vishing (voice-mail), SMSishing (Text messages), whaling (Targeted phishing on high net worth individuals), Card duplication Techniques apart from stealing confidential data to perpetrate Frauds.

Deposit related Frauds – Lack of compliance with KYC Guidelines, misuse of inoperative accounts, Non-reconciliation of Suspense and Sundry Accounts and lack of control over transactions, in these accounts, result in frauds.

Advances Portfolio Frauds – Majority of credit related frauds are on account of deficient appraisal system, Poor post- disbursement supervision and inadequate follow-up. Most of the frauds relating to advances come to light only during the recovery process initiated after the accounts have been classified as NPA. Fabricated/fudged Financial Statements, inflated security valuation report, defective search report for title deeds of mortgaged property are commonly discovered.

The most effective way of preventing frauds in loan accounts is for banks to have a robust appraisal and an effective credit monitoring mechanism during the entire life-cycle of the loan account. Any weakness that may have escaped attention at the appraisal stage can often be mitigated, in case the post disbursement monitoring remains effective. In order to strengthen the monitoring processes, inclusion of the following checks during the different stages of the loan life-cycle should be carried out:

(a) Pre-sanction: As part of the credit process, the checks being applied during the stage of pre-sanction may consist of the bank collecting independent information and market intelligence on the potential borrowers from the public domain on their track record, involvement in legal disputes, raids conducted on their businesses, if any, validation of submitted information/data from other sources like the ROC, scanning the defaulters list of RBI/other Government agencies, etc., which could be used as an input by the sanctioning authority.

(b) Disbursement: Checks during the disbursement stage, shall, among others, focus on the adherence to the terms and conditions of sanction, rationale for allowing dilution of these terms and conditions, level at which such dilutions were allowed, etc. The dilutions should strictly conform to the broad framework laid down by the Board in this regard. As a matter of good practice, the sanctioning authority may specify certain terms and conditions as 'core' which should not be diluted.

(c) Annual review: While the continuous monitoring of an account

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through the tracking of EWS is important, banks also need to be vigilant from the fraud perspective at the time of annual review of accounts. Among other things, the aspects of diversion of funds in an account, adequacy of stock, stress in group accounts, etc., should also be considered at the time of review. Besides, the Bank should track market developments relating to the major clients of the bank. This would involve collecting information from the grapevine, following up stock market movements, subscribing to a press clipping service and monitoring databases on a continuous basis.

RBI Master Directions on Frauds dated. 1st July 2016 lists out 42 Early Warning Signals of Frauds. They can be classified into following categories -

1. Operations 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.
2. Concealment or Falsification of documents – Substantial increase in unbilled revenue year after year, poor disclosure of materially adverse information, material discrepancies in annual report, etc.
3. 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.
4. Issues in Primary/Collateral 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.
5. Inter-Group/Concentration of Transactions – 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.
6. Regulatory Concerns – Default in undisputed payment to the statutory bodies, raid by Tax Authorities.
7. Others - Resignation of key personnel and frequent changes in management, significant reduction in stake of promoters, etc.

These Early Warning Signals are red flags, which need immediate attention and action by the Management of the Banks. The classification given above is broad, and various instances can overlap each other.

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Therefore, it should be remembered that –

- (a) No one signal can be seen in isolation
- (b) Existence of such signals does not necessarily mean that there is a fraud
- (c) In case of fraud, several signals would appear together

Bank should build processes and control for prevention and timely detection of frauds. Such controls can be internal or external, manual or information technology- based. Timely scrutiny of the data received by the management having appropriate knowledge can only be the effective check on frauds.

Various Early Warning Signals and the responses of the Bank Management and Auditors to such signals, as well as the use of Information Technology by Fraudsters in committing frauds have been given in detail in subsequent write-ups.

Frauds Risks involving Information Technology (IT)

Definitions

Fraud is defined as a wrongful or criminal deception intended to result in financial or personal gain. The Key element is **Intent**.

Information Technology (IT) is the study or use of systems (especially computers and telecommunications) for storing, retrieving, and sending information.

Error is the state or condition of being wrong in conduct or judgment.

With rapid advances in Technology, its enabler element can be used for wrong purposes with ulterior motives. IT in this case can be a bane or a curse. The advantages a fraudster has in this case is speed of conducting an Transaction, being physically absent while the transaction is conducted, covering up the tracks in the meantime, ability to hide or destroy the audit trail leaving no evidence.

We are talking in the present context only of how IT can be misused by a Borrower to –

1. Obtain funds to which he is not entitled by fabricating Financial statements , Books of accounts & other records
2. Divert & Siphon Funds & destroy audit trail

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3. Fabricate Monthly monitoring statements submitted to Bank like Stocks & debtors –
4. Misuse / sell or tamper securities charged to the Bank without their knowledge
5. Maintain parallel set of books of accounts , Inventory, Debtors & other Registers
6. Fabricate Security Documents like Title deeds, original ownership documents etc

Some of the types of Frauds that can be committed using IT –

1. Mortgage Fraud
2. Occupancy Fraud
3. Income Fraud
4. Employment Fraud
5. Fraud for profit
6. Appraisal Fraud
7. Cash-back schemes
8. Shot-gunning
9. Working the GAP
10. Identity Theft etc.

Brief Descriptions –

- **Mortgage fraud** is done with the intent to materially misrepresent or omit information on a mortgage loan application in order to obtain a loan or to obtain a larger loan than could have been obtained had the lender or borrower known the truth. With increasing automation and encouragement for digitization, the first impressions of the borrowers are adjudged on the basis of the scan copies of the documents which are prone to alterations or adjustments from the users' end to serve their purpose.
- **Occupancy fraud** occurs where the borrower wishes to obtain a mortgage to acquire an investment property, but states on the loan application that the borrower will occupy the property as the primary residence or as a second home. If undetected, the borrower typically obtains a lower interest rate than was warranted. Because lenders

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typically charge a higher interest rate for non-owner-occupied properties, which historically have higher delinquency rates, the lender receives insufficient return on capital and is over-exposed to loss relative to what was expected in the transaction. In addition, lenders allow larger loans on owner-occupied homes compared to loans for investment properties. When occupancy fraud occurs, it is likely that taxes on gains are not paid, resulting in additional fraud. It is considered fraud because the borrower has materially misrepresented the risk to the lender to obtain more favourable loan terms.

- **Income fraud** occurs when a borrower overstates his/her income to qualify for a mortgage or for a larger loan amount. This was most often seen with so-called "stated income" mortgage loans (popularly referred to as "liar loans"), where the borrower, or a loan officer acting for a borrower with or without the borrower's knowledge, states without verification the income needed to qualify for the loan. Because mortgage lenders today do not have "stated income" loans, income fraud is seen in traditional full-documentation loans where the borrower forges or alters an employer-issued Form 16, salary slips, tax returns and/or bank account records to provide support for the inflated income. It is considered fraud because in most cases the borrower would not have qualified for the loan had the true income been disclosed. The "mortgage meltdown" was caused, in part, when large numbers of borrowers in areas of rapidly increasing home prices lied about their income, acquired homes they could not afford, and then defaulted. Banks could not recover their dues as the Market values of properties fell & High Loan to value Ratios ensured a deficit or a loss to the bank in terms of higher provisioning.
- **Employment fraud** occurs when a borrower claims self-employment in a non-existent company or claims a higher position (e.g., manager) in a real company, to provide justification for a fraudulent representation of the borrower's income. The fictitious records can easily be created using IT and the main characteristics of these records are that they usually seem genuine unless someone specifically probes into them.
- **Fraud for profit** is a complex scheme involving multiple parties, including mortgage lending professionals, in a financially motivated attempt to defraud the lender of large sums of money. Fraud for profit schemes frequently include a straw borrower whose credit report is used, a dishonest appraiser who intentionally and significantly

overstates the value of the subject property, a dishonest settlement agent who might prepare two sets of settlement statements or makes disbursements from loan proceeds which are not disclosed on the settlement statement, and a property owner, all in a coordinated attempt to obtain an inappropriately large loan. The parties involved share the ill-gotten gains and the mortgage eventually goes into default. In other cases, naive "investors" are lured into the scheme with the organizer's promise that the home will be repaired, repairs and/or renovations will be made, tenants will be found, rents will be collected, mortgage payments made and profits will be split upon sale of the property, all without the active participation of the straw buyer. Once the loan is closed, the organizer disappears, no repairs are made nor renters found, and the "investor" is liable for paying the mortgage on a property that is not worth what is owed, leaving the "investor" financially ruined. If undetected, a bank may lend hundreds of thousands of rupees against a property that is actually worth far less and in large schemes with multiple transactions, banks may lend significantly higher amounts that are far more than the properties are actually worth.

- **Appraisal fraud** occurs when a home's appraised value is deliberately overstated or understated. When overstated, more money can be obtained by the borrower in the form of a cash-out refinance, by the seller in a purchase transaction, or by the organizers of a for-profit mortgage fraud scheme. Appraisal fraud also includes cases where the home's value is deliberately understated to get a lower price on a foreclosed home, or in a fraudulent attempt to induce a lender to decrease the amount owed on the mortgage in a loan modification. A dishonest appraiser may be involved in the preparation of the fraudulent appraisal, or an existing and accurate appraisal may be altered by someone with knowledge of graphic editing tools such as *Adobe Photoshop*.
- **Cash-back schemes** occur where the true price of a property is illegally inflated to provide cash-back to transaction participants, most often the borrowers, who receive a "rebate" which is not disclosed to the lender. As a result, the lender lends too much, and the buyer pockets the overage or splits it with other participants, including the seller or the real estate agent. This scheme requires appraisal fraud to deceive the lender. "Get Rich Quick" real-estate gurus' courses frequently rely heavily on this mechanism for profitability.

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- **Shot-gunning** occurs when multiple loans for the same home are obtained simultaneously for a total amount greatly in excess of the actual value of the property. These schemes leave lenders exposed to large losses because the subsequent mortgages are junior to the first mortgage to be recorded and the property value is insufficient for the subsequent lenders to collect against the property in foreclosure. The result of this fraud is that lenders often litigate to decide as to who has first priority to the property.
- **Working the gap** is a technique which entails the excessive lien stacking knowingly executed on a specific property within an inordinately narrow timeframe, via the serial recording of multiple Deeds of Trust or Assignments of Note. When recording a legal document in CERSAI, a time gap exists between when the Deed of Trust is submitted to CERSAI & when it actually shows up in the data. The precision timing technique of "working the gap" between the recording of a deed & its subsequent appearance in the recorder of deeds database is instrumental in propagating the perpetrator's deception. A title search done by any lender immediately prior to the respective loan, promissory note, & deed recording would thus erroneously fail to show the alternate liens concurrently in the queue. The goal of the perpetrator is the theft of funds from each lender by deceit, with all lenders simultaneously & erroneously believing their respective Deeds of Trust to be senior in position, when in actuality there can be only one. White-collar criminals who utilize this technique will frequently claim innocence based on clerical errors, bad record keeping, or other smokescreen excuses in an attempt to obfuscate the true coordination & intent inherent in this version of mortgage fraud. This "gaming" or exploitation of a structural weakness is a critical precursor to "shot-gunning" and considered white-collar crime when implemented in a systemic fashion.
- **Identity theft** occurs when a person assumes the identity of another and uses that identity to obtain a mortgage without the knowledge or consent of the victim. In these schemes, the thieves disappear without making payments on the mortgage. The schemes are usually not discovered until the lender tries to collect from the victim, who may incur substantial costs trying to prove the theft of his/her identity.
- **Falsification of loan applications without the knowledge of the borrower:** The loan applications are falsified without the knowledge of

the borrower when the borrower actually will not qualify for a loan for various reasons (*like parties involved will make a commission out of the transaction*). The transaction happens only if the loan application is falsified. For example, borrower applies for a loan stating monthly income of Rs. 20,000 (but with this income Rs. 20,000 per month the borrower will not qualify). However, the broker or loan officer falsified the income documents and loan application that borrower earns a monthly income of Rs. 50,000. The loan gets approved, the broker/loan officer etc. get their commission. But the borrower struggles to repay the loan and defaults in payment of the loan eventually.

- **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. The word is coined on the analogy of the fishing technique of using a bait to lure the victim. It directs users to enter details in a fake website whose look & feel are almost identical to the legitimate one. It exploits the users' inability to identify the genuine from the fake site being visited or the program being used by them.
- **Manipulation** – By just changing or adjusting a few formulas in Excel, you can manipulate the ratios to your advantage. A Bank will typically look at some standard ratios like Current & Quick Ratio, Debtors, Creditors & Fixed asset Turnover Ratio, Debt Service Coverage Ratio, Profit Before & after Tax ratios, Debt Equity ratio, Return on Next worth or on Capital Employed – Use of it makes it easy for a dishonest borrower to maintain parallel set of records or to adjust current set of records to match the ratios.

An in-depth verification of –

1. Books of accounts
2. Scrutiny & reconciliation of Bank statements
3. Matching Cash flows with Financial statements & actual bank Transactions
4. External VAT / Service Tax Returns & IT returns
5. ROC records
6. Personal discussion with statutory & internal auditors
7. Independent Market information with Creditors / Debtors

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will enable the manipulation to be detected but since banks lack time & resources to cross-corroborate data shared by the borrower, it becomes easier for the scrofulous borrower to manipulate data submitted to the Bank & adjust his records, statements & other submissions by using IT.

If any internal staff is a part of the manipulation conspiracy, then the work of the borrower becomes that much easier.

In various Fraud instances, we have seen fabrication of original title deeds, Manipulation of stock, debtors & creditors statements, Manipulation of valuation reports, Manipulation of financial statements, replacement of records, Maintenance of parallel set or manipulated set of Inventory Registers, Fixed asset, Debtors - Creditors Registers, Tax challans & returns, ROC records & returns, fraudulent PAN, Address & Identity Proofs, manipulation of e-mail Id & telephone numbers – hacking of email Id's- destruction of audit trail etc. which to a larger extent have been facilitated or made easier by use of IT.

It should be noted that the same IT could also be used effectively to develop pro-active & preventive checks to stop frauds from happening or minimize or lessen the detection time & reduce the impact / loss.

Hence it is critical to understand how IT can be misused so that we can take appropriate steps to ensure this misuse does not happen or we reduce / minimize or zeroise the impact due to the misuse.

Vigilance Function in banks – All banks have a vigilance department, though it may be assigned different names in different banks. Its functions include- to keep surveillance over the suspect staff/transactions, to look into cases of frauds/misappropriation/connivance, etc. leading to loss to the bank. In the case of large non-performing assets, the department may be required to investigate and find out the reasons for the account becoming non-performing. The nature of findings of the vigilance department is of relevance to the auditor, particularly in evaluating the efficacy of internal controls.

Conclusions – Proper training needs to be provided to the banking staffs about the risks and the banks should develop appropriate policies and procedures wherein even if the data is received via IT, the subsequent procedures ensure that the data so obtained is authentic and can be relied upon.

The staffs should also be sensitized about their accountability and the existence of strict vigilance mechanism to prevent and detect such frauds

and errors. This will discourage the potential fraudulent employees knowing that they are being continuously monitored.

Recognition & awareness of the risk & after due risk appreciation, devising effective pro-active, preventive measures on an ongoing, continual basis with frequent reviews by internal or external resources to check efficacy of the controls implemented for remediation / reduction / elimination & suggesting, implementing steps to plug gaps is the way forward

“Identifying early warning through the use of IT signals.”

1. Now that all operations are technology based, IT plays an important role in identifying warning signals in relation to bank frauds. In a similar fashion, for the first time IT has been extensively used by the Income Tax department to identify the persons and firms who need to be questioned/investigated based on the “early signals” of depositing black money in bank accounts, by adopting different modus operandi, after demonetization decision of 8th November 2016.

2. Earlier when banks were having manual accounting systems of business operations, it was not unusual to manipulate the customer accounts, delay in getting information, difficult to identify and correlate the information from other similar accounts in same bank or from other banks. It was also difficult to identify any signals to have in-depth study due to unavailability of details about the customer having operations in multiple banks.

3. The early signal of frauds in banks can be many, out of them some are being dealt below. The same can be identified through IT and can be investigated in detail so as to confirm whether something is wrong and also to take preventive measures.

4. With the use of IT in banks, any number of reports can be generated on a regular basis: for example, every day the IT system generates a report which is known as “report of abnormal/exceptional transactions” that includes abnormal deposit/withdrawal of cash from the various accounts, operations in the inoperative accounts, abnormal debit or credit entries, excess withdrawals permitted that might have resulted in clean (unsecured) overdraft without any sanction, someone withdrawing the amount from accounts of other persons, advances permitted without lending powers, some customer being allowed advance without having any/insufficient securities etc. This is very important report which must be analyzed in great detail to get

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indications about early signals. Another report, which will be of great help, is report on cash transaction of high value.

5. Some examples of early signals:

5.1 Bills discounted are paid on due dates every time and there are no delays or return of bills.

This signal can be identified on the basis of report generated of all the bills discounted by the bank in the customers' accounts, during a specified period. The report will have details about the date the bill has been paid and the sources for such payments. In this report, if the bank observes that almost all the bills are being paid on due date neither earlier nor later than due date, this will be a matter of definite suspicion. It can't be possible in normal business. NO customer will be sitting with a due date diary all the time, and it is not possible to arrange payment of all bills exactly on due dates. The Reserve Bank of India also permits up to 10% return as a normal return of bills that means no one expects NIL return of bills in normal course of business. In any business, sometimes liquidity problems will arise that may result in delay in making payment against bills. There may be situations when liquidity is more, the customer may make payment earlier than due date.

When all payments are made on due date, it had been my experience that the customer had used the modus operandi of discounting dummy bills so as to generate funds for arranging payment of bills on due dates. The customer may discount bills drawn on a sister concern, with or without any commercial transaction, and the sister concern will be asked by the customer to make the payment of bill on due date. I have observed in some cases that the customer who discounted the bills, himself sends the funds for the payment of bills on due dates. Therefore, such account should not be taken as "A" category account; instead this type of situation needs investigation.

5.2 From the reports generated, it should be possible to identify the problem like **heavy income from other sources, shown in the financial statement of accounts, unrelated to the normal business of the customer**. If in-depth study is carried out about such income, it may be found that possibly the customer is diverting the funds to areas not related to his normal business, such as capital market, commodity market, real estate market and bullion market.

This situation indicates that the customer is not concentrating on his main business and involving in speculative markets which will be harmful for the business concern and may result in serious liquidity problems as well as heavy losses.

- 5.3 Another signal that can be identified through IT data base is **heavy borrowing of funds for short term in quarter/half year/year ending months for a few days and being used for deposits of similar or lesser period in the market**. From the churning and analysis of the data, it can be easily found out that the transactions are not business transactions; instead the customer is using the short term borrowings for providing short term deposits to banks nearing the period for closing of accounts. This type of operations are used to earn hefty profits through spreads, between lower interest rates on short term finances from banks and high interest rates on short term deposits taken by the banks for inflating the deposits and advances figures.
- 5.4 **Diversio**n can be identified from the IT generated reports that the funds taken by the customer have been used for the purpose for which the finance was taken or not. It is correct that it can be identified through Cash-Flow statement also but that will be too late i.e., it will be possible when the financial statement of accounts is prepared. Yes it can be done earlier by generating IT reports of short term & long term funds raised from various sources. This will show whether the funds are used properly i.e. short- term in short term and long- term in long term requirements. This analysis will identify early signals that the short- term funds have been used for long term requirements. This type of use is taken seriously by the banks as a part of financial mismanagement at the customer level. It will result in serious liquidity problems and risk of default will arise. The repayment of short term funds will be due in a short period but the funds used for long term purpose will not generate sufficient funds for liquidating/paying short term dues and the customer will face the real threat of default. Therefore, the an early signal will provide an opportunity to the bank to take immediate corrective steps.
- 5.5 There is another area when **customer starts operating accounts in other bank without intimation to the main bank** for which early signals can be found out through use of IT. The bank can obtain a data report about the total payments (Total debit summations) made vis-a-vis total purchases and Total payments received (Total credit

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summations) vis-a-vis total sales. If major mismatch is observed, that will indicate that customer is operating the business operations from other sources, not in the knowledge of the bank. These sources may be the finance being obtained from the shroffs (money lenders) and other banks, indicating that the customer habitually borrows from sources not disclosed to the bank and adjusts such loans before Quarter/Half/yearly closings with an intention not to reflect the same in the financial statement of accounts.

- 5.6 **The customer account may be having a lot of cash deposits and withdrawals.** Such large number of cash transactions can be identified through IT by generating reports pertaining to cash transaction, on a regular basis above a certain amount, to indicate requirement of in-depth study. These deposits or payments may finally show that these may not be genuine transactions.
- 5.7 IT provides common data base for a customer from all accounts in all banks. IT reports can identify the **misuse of funds, money laundering, multiple mortgagees of same property to different banks/institutions and deposits kept in various banks.** Through such reports banks could identify the borrowers who have taken multiple housing loans on the same house. This data base will also show the deposits which are in lien with the banks but not disclosed by the customer. Reports can be generated to identify deposits and accounts with common addresses, common account holders and common directors. This information may help in finding out Benami accounts/deposits/assets.
- 5.8 IT has **successfully converted the branch banking to a single bank** and the customer enabled to operate any account in any branch of a bank from anywhere. Now the Reserve Bank of India is in the process of connecting all the banks with one server that will help RBI to properly monitor the banking industry and to have early signals for the things that may go wrong. The IT helps the bank to use flagging for different types of warning signals and the system will signal to the bank and auditors, whenever such trouble is expected to arise.
- 5.9 CIBIL is the live example of **creating a common data base** for all borrowers and the system identifies the problematic borrower accounts.
- 5.10 It can develop reports which can help in identifying the signal **indicating fall in performance of the bank in its business in comparison** to other similar banks.

- 5.11 IT can help in signaling the situation such as:
- (a) Same goods/stock are provided as the security by the main borrower or associate firms to the same bank in different branches resulting in several times credit facility in relation to the small security
 - (b) Fraudulent transfer of funds from customer accounts
 - (c) Diversion of funds to other projects/product to dilute security.
6. IT has made it possible by use of PAN/Adhaar numbers to identify the accounts/deposits kept with many branches/banks by the customers to avoid tax deduction at source (TDS) or avoid payment of tax itself.

SECTION 1

Operations of Account

Signal No. 1. Bouncing of high value cheques

(a) Introduction

The health of an account is known from the transactions carried out by the borrower in his account. Depositing of cheques received from the customers and withdrawals from the account through cheques are normal banking transactions, which a borrower usually carries out in his account. The borrowers are granted working capital limits based on their eligibility and are required to operate their account within the limits specified and mentioned in the system of the Banks.

(b) Risk/Fraud Indicators/Source of Information

One of the main signals of an account turning bad is frequent bouncing of cheques in the account. This is the first signal, which gives a hint that there are problems in the account and it needs monitoring. Many a time it has been observed that the borrowers deposit high value cheques in their account to bring down the outstanding within the sanctioned limits and latter these cheques are not cleared and reversed in the account. The borrowers carry out such transactions to buy time so that the account does not become NPA. When the account is continuously overdrawn, then high value cheques are deposited by the borrowers to bring down the outstanding temporarily. Outstation cheques or cheques from co-operative banks are deposited so that there is a time lag in the clearance of the cheques and the system treats them as regular deposits and does not flag these accounts as NPA. After the 3 month period the cheques bounce and are reversed by the system. These reversals are again treated as regular withdrawals by the system and not considered back- dated to treat the account as NPA.

Frequent bouncing of cheques results in high risk for the banks as this might lead to the account turning bad. 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.

(c) Bank's Control – Prevention or Detection

Most of the CBS Banks have controls established in the system itself to identify such accounts wherein there are high value cheques bouncing. The

system raises red flags on such transactions and mentions these accounts in the exception reports. The Bank can detect such accounts from the exception reports and manual scrutiny of the accounts and restrict withdrawals from the account against such fraudulent deposits. The borrower may be warned by sending letters to them and also the staff asked to monitor the account on a constant basis so that the account does not turn NPA due to such fraudulent activity.

(d) Audit Process

The auditor needs to check the exception reports and identify such accounts. The exceptions reports are generated on a daily basis or fortnightly/monthly basis. Repetition of the same accounts in these reports raises concern and the auditor has to check the account and alert the Branch and mention the same in his audit report.

The auditor has to ascertain whether the Branch is allowing the borrower to withdraw funds against such deposits. Also the auditor has to confirm that such deposits are not used to mislead the system in missing out flagging the account as NPA. All the window-dressing transactions should be checked thoroughly and reported to the Bank and immediately advise the Branch to take corrective action.

(e) Case Study

➤ In one of the cases, it was observed that the borrower was utilizing the sanctioned fund based limits fully. To over-utilize the limits and not allow the system to flag the account as NPA the borrower was always in the habit of depositing high value cheques from his account maintained in a rural co-operative bank. The cheques deposited would bring down the outstanding limits and he would use this limit to withdraw funds from the account. After a lag of few days the cheques would bounce and get reversed and he would make these transactions good by depositing new high value cheques and occasionally by cash deposits. The system never classified the account as NPA and the borrower was always able to enjoy the facility through this mechanism. At the year end the statutory auditor could trace this account from the exception reports and after scrutiny of the account the deposits were ignored by the auditor and post-recalculation of the number of days the account was overdrawn, it was classified as NPA.

➤ In another instance in a large account, the Branch Manager had obtained high value cheques from the borrower and the same were entered in the system as credits in the account of the borrower and the account did

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not slip to NPA. These high value cheques were never sent for clearing and the corresponding debit kept lying in the suspense account. The borrower had requested the Branch Manager for sometime for him to arrange the funds so that the cheques could be cleared later. In this case the concurrent auditor checked the old suspense entries and ascertained the nature of transactions and reported to the higher authorities and later the account was classified as NPA.

Signal No. 2. Foreign bills remaining outstanding with the bank for a long time and tendency for bills to remain overdue

1.0 Introduction:

International trade involves movement of goods and matching payment settlements in various currencies. Export results in depletion of the wealth of a nation and imports create demand for currencies of other countries. In our country, the demand for foreign exchange exceeds the supply and hence foreign exchange is considered a scarce commodity.

As international anti-money laundering (AML) and counter-terrorist financing efforts of targeting cash smuggling and misuse of the financial system have matured and strengthened, money launderers and terrorist financiers have increasingly turned to global trade as a venue for moving illicit funds across borders and integrating them into the formal economy.

Why is trade finance garnering more and more attention from regulators and money launderers alike? The simple answer is success—by both the good guys and the bad. Due to the more extensive and effective Anti-Money Laundering (AML) controls that financial institutions are applying to combat cash smuggling schemes and financial system abuse, manipulation of trade finance is becoming more and more appealing to financial criminal and is becoming more profitable. Though the underlying techniques of most Trade-Based Money Laundering (TBML) schemes are straightforward and relatively simple, they are difficult to detect because they are layered within the mass of legitimate payments flowing through the byzantine web of global trade. TBML techniques range from simple fraud to the leveraging of complex networks of trade and financial transactions. **At the most basic level, launderers transfer funds between countries by misrepresenting the price, quantity, or quality of invoiced goods on invoices and customs declaration forms.** As long as the difference between the real value and the

stated value of the goods is not obvious, the odds of detection by regulators and other interested parties are near zero.

What do you understand by a 'Foreign Bill. Bill means 'Bill of Exchange'.

When a commercial transaction is undertaken by two parties stationed at different countries, the transaction involves Bill of Exchange drawn by the 'Seller' stationed in one country, on the 'Purchaser' stationed in another country.

There are two stages in getting Bank credit facility for the goods for Export:

- (i) **Pre-shipment Stage** : The Exporter Customer can approach his Banker with a request for Credit facility to process, procure, and manufacture the goods involved in the transaction.*
- (ii) **Post-shipment Stage** : When the Goods are ready for shipment, he has to prepare the Documents: viz. Invoice, Packing List, Certificate of Origin, Other Quality Certification, as per terms of Purchase Order or the LC along with the bill of exchange drawn by him on the Overseas Buyer. The Exporter is the 'Drawer' of the Bill, the Overseas Buyer is the 'Drawee' of the Bill and the Exporter's Bank is made the beneficiary to receive the amount involved on behalf of the Exporter. Based on the Tenor of the Bill and as per terms of Purchase Order or the Export LC, the Bill of Exchange is made up either as DP or DA.*

DP Bill means: Documents of Title to the Goods to be delivered /endorsed in favour of the Overseas Buyer against Payment as contained in the Bills of Exchange.

DA Bill means: Documents of Title to the Goods to be delivered /endorsed in favour of the Overseas Buyer against 'Acceptance' to pay the relevant amount on the 'Due Date' as contained in the Bills of Exchange or as may be determined as per Terms of the Purchase Order or the Export LC.

If no Credit facility: If Pre-Shipment or Post-Shipment; is availed, then the Documents are sent on 'Collection' Basis for realising the Export Bill.

All stages for movement of Documents and necessary compliances are the same whether Documents are sent on Collection basis or finance raised under the Documents are drawn under the LC.

2.0 Risk/ Fraud Indicators

The stage where it is obligatory on the 'Importer' (i.e. the Overseas Buyer) , to effect the payment at his importing stage in favour of the exporter (i.e. to

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be received here in India) it is obligatory on the Exporter's Bank also to ensure receipt of the relevant amount on or about the Due Date.

Despite this, there are overdue export realizations in every Bank. Non-receipt of Payment of Export Bills may occur due to various reasons:

- (i) Overseas Buyer finding the goods or the time of receipt of the goods not as per contracted terms: Quality, Quantity and Delivery Schedule and mode of shipment (partial shipment allowed / not allowed etc.). Discrepancies of such nature and others, if not earlier conveyed to the exporter at the other end, and not approved by the overseas buyer are of vital importance while parting with the Document of Title to the Goods; namely, Bill of Exchange duly 'Accepted' by the Drawee (the importer at the other end), with Bill of Lading duly endorsed in his favour and all other relevant documents.
- (ii) Negotiation of the Bills drawn under the LC or the relevant Confirmed Order should be within the stipulated time.
- (iii) Shipment of the goods also should be as per the time (i.e. Date) specified in the LC or the Contracted terms as per Confirmed Purchase Order.
- (iv) There are other conditions e.g. Certificate of Origin to be from Competent Authority of the respective country, Packing List. Etc.
- (v) Pendency of Export Bills realisation is more possible in case of Exports against Confirmed Orders and Bills sent under 'Collection' Basis only. Further, some Banks are not insisting upon exporter obtaining ECGC Insurance Cover. Here, Credit Reports of International Agencies become more relevant.

There are possibilities of unhealthy 'tie-ups' between the Exporter at 'Sale end' and the Importer at the 'Purchase-end'. Such 'tie-ups may be for ulterior motives of some 'mischief' and the Foreign Remittance may not come forth for a long time or may not come at all. In order to arrest such possibilities, Credit Reports at International levels, 'Informal' discreet reports from similar business houses can be of avail.

Every Bank or Financial Institution dealing in Foreign Exchange has to organise 'follow-up' as per the 'age' of the overdue position of Export Realisations. Longer the age of 'Overdue' position, more the reason to view it with circumspection. Bank must decide 'time-frame' for reaching conclusive position in such cases.

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In cases of delay attributable to business disputes; e.g. Quality, Quantity time of delivery etc. amicable solutions by concerned parties should be thrashed out within reasonable time, for which Bank's frequent follow-up may be of good avail. Exporter's complacency should not be accepted. RBI has formulated guidelines, including tolerance levels of short receipts, time limit beyond stipulated time limit etc. in such cases. Intervention by even Foreign Embassy Offices of the respective countries is possible. Despite all these if overdue position persists, then it should be treated as a 'pointer' to probe into the matter. Then even legal recourse at international level should be resorted to.

Realisation of Export Bills must be achieved since 'Wealth' of our nation has gone out for which 'Monetary' Consideration must be obtained. Unreasonable delay or non-receipt is virtual 'theft' of the Nation's Wealth. Judicious applications of the RBI's provisions in cases of delays should be done in good time and any claims entertainable by the ECGC should be filed in good time, or the last recourse of legal remedy should never be lost due to any negligence or complacency on the part of the staff at any level.

2.1 Common TBML techniques

Sr. No.	Risk	Fraud Indicators
1.	Under-invoicing	Invoicing trade goods at a price below the fair market price, which enables the exporter to transfer value to the importer, as the payment for the trade goods will be lower than the value the importer receives when it re-sells the goods on the open market. Under-invoicing enables the exporter to transfer value to the importer.
2.	Over-invoicing	Invoicing trade goods at a price above the fair market price, which enables the importer to transfer value to the exporter, as the payment for the goods is higher than their true value. Over-invoicing enables the importer to transfer value to the exporter.
3.	Multiple invoicing	By issuing more than one invoice for the same international trade transaction, a

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Sr. No.	Risk	Fraud Indicators
		<p>money launderer or terrorist financier can justify multiple payments for the same shipment. Payments can originate from different financial institutions, adding to the complexity of detection, and legitimate explanations can be offered if the scheme is uncovered (e.g., amendment of payment terms, payment of late fees, etc.)</p> <p>Multiple invoicing: a money launderer or terrorist can justify multiple payments for the same shipment.</p>
4.	Over- and under-shipment	<p>Overstating or understating the quantity of goods shipped relative to the payments sent/received. The most extreme cases involve “phantom shipments” where no goods are shipped, but shipping and customs documents are processed as normal.</p> <p>Over- and under-shipment most extreme cases are “phantom” shipments.</p>
5.	False description of trade goods	<p>A money launderer may misrepresent the quality or type of the trade goods; for example, substituting an inexpensive product for the more expensive item listed on the invoice and customs documents</p> <p>False description of trade goods misrepresenting the quality or type of the goods.</p>

3.0 Bank’s Control – Prevention or Detection

In our country, Export trade is regulated by the Directorate General of Foreign Trade (DGFT) and its regional offices, functioning under the Ministry of Commerce and Industry, Department of Commerce, Government of India. Policies and procedures required to be followed for exports from India are announced by the DGFT, from time to time.

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Prior to export of goods to any country, the exporter should furnish a declaration on

- (i) The full export value of goods, or if
- (ii) The exact value is not ascertainable, the expected value has been or will be paid within the period and in the manner as prescribed by Exchange Control.

The prescribed export declaration forms concerning bankers are:

- (i) GR Form: Export to all countries made otherwise than by post.
- (ii) PP Form: Export to all countries by post parcel, other than on VP COD basis.
- (iii) Softex Form: Export of computer software in non-physical form.

While GR /PP forms are made in two copies, VP / COD forms are to be submitted in a single copy and Softex form is prepared in three copies. Where the specified categories of shipping bills are processed electronically, the declaration in Form SDF (Statutory Declaration Form) in respect of such shipping bills shall be submitted. GR forms (with manual shipping bill) / SDF (with computerised shipping bill) will be submitted to customs, PP forms will be tendered to post office. Softex forms will be submitted to Department of Electronics (DOE) located in software technological park (STP) or electronic hardware technological park (EHTP)

3.1 Time Limit for Realisation of Export Proceeds

It is obligatory on the part of the exporter to realize and repatriate the full value of goods / software / services to India within a stipulated period from the date of export, as under:

- (i) Period of realization and repatriation of export proceeds shall be nine months from the date of export for all exporters including Units in Special Economic Zones (SEZs), Status Holder Exporters, Export Oriented Units (EOUs), Units in Electronic Hardware Technology Parks (EHTPs), Software Technology Parks (STPs) & Bio-Technology Parks (BTPs) until further notice.
- (ii) For goods exported to a warehouse established outside India, the proceeds shall be realized within fifteen months from the date of shipment of goods.

3.2 Manner of receipt and payment

- (i) The amount representing the full export value of the goods exported

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shall be received through an AD Bank in the manner specified in the Foreign Exchange Management (Manner of Receipt & Payment) Regulations, 2016 notified vide Notification No. FEMA.14 (R)/2016-RB dated May 02, 2016.

- (ii) When payment for goods sold to overseas buyers during their visits is received in this manner, EDF (duplicate) should be released by the AD Category – I banks only on receipt of funds in their Nostro account or if the AD Category – I bank concerned is not the Credit Card servicing bank, on production of a certificate by the exporter from the Credit Card servicing bank in India to the effect that it has received the equivalent amount in foreign exchange, AD Category – I banks may also receive payment for exports made out of India by debit to the credit card of an importer where the reimbursement from the card issuing bank/ organization will be received in foreign exchange.

3.3 AD Category – I banks should maintain Export Bills Register, in physical or electronic form. Details of EDF/SOFTEX form number, due date of payment, the fortnightly period of R Supplementary Return with which the ENC statement covering the transaction was sent to the Reserve Bank, should be available.

3.0 AD Category – I banks should ensure that all types of export transactions are entered in the Export Bills Register and are given bill numbers on a financial year basis (i.e. April to March).

3.5 The bill numbers should be recorded in ENC statement and other relevant returns submitted to the Reserve Bank.

3.6 Follow-up of Overdue Bills

Delay in realisation of export realisable gives a EWS (Early Warning Signal) of the account moving towards Non-Performing Asset. AD Category – I banks should closely watch realization of bills and in cases where bills remain outstanding beyond the due date for payment from the date of export, the matter should be promptly taken up with the concerned exporter. If the exporter fails to arrange for delivery of the proceeds within the stipulated period or seeks extension of time beyond the stipulated period, the matter should be reported to the Regional Office concerned of the Reserve Bank stating, where possible, the reason for the delay in realizing the proceeds.

3.7 Export Outstanding Statement (XOS)

Authorized dealers should closely watch the realization of bills and in case

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where bills remain outstanding beyond the due date for payment, they should take up the matter promptly with the exporter concerned.

With effect from March 01, 2014, details of all export outstanding bills can be obtained from the EDPMS. AD category – I banks were, however, required to report the old outstanding bills prior to March 01, 2014 in XOS on half-yearly basis as at the end of June and December every year. To reduce the reporting burden of AD Category – I banks, it has been decided to migrate the XOS data reported by the AD banks for half year ended December 2015 onwards to EDPMS (**Export Data Processing and Monitoring System**) and discontinue separate reporting of XOS for the subsequent periods. AD category – I banks are required to mark off / close the XOS data pertaining to pre-March 01, 2014 as and when the amount has been realized.

4.0 Audit Process

For auditing export sales, it is preferable that a detailed report of all exports made during the year is made available. The detail should in general consist of basic information like commercial invoice number, buyer's name, product name, quantity sold, price per unit, value term / INCOTERM applied, date of B/L, value of sales on date of B/L, settlement advice number of payment received, shipping bill number, FOB value, export incentives, export related expenses etc.

The Export bills register must be scrutinized thoroughly along with the supporting documents; verify that guidelines as per FEMA are properly taken care of; the returns are submitted to concerned authorities with appropriate data.

Apart from the above, following are the important check points for Export Bills

Sr. No.	Check points
1.	Whether the export bills purchased/negotiated are within discretionary powers of the Branch Manager or sanctioned limits.
2.	Whether the export bills purchased are covered under Whole Turnover Post Ship Guarantee as well as the ECGC Policy obtained by the exporter.
3.	Whether the export documents are submitted to the bank for negotiation within the stipulated period of 21 days from date of shipment.

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4.	Whether the export documents are thoroughly scrutinized before negotiation to ensure that they strictly conform to the terms of letter of Credit/firm order.
5.	Whether in the cases where bills remain unrealized beyond the prescribed period, the matter is promptly taken up with the exporter and if he fails to arrange remittance of proceeds, the matter is reported to RBI with reasons for delay.
6..	Whether it is ensured that documents pertaining to the title of goods i.e. bills of lading/airway bills are with full set of documents received under import letter and documents are thoroughly examined.
7.	Whether proper entries are made in the prescribed register and usance bills presented to the drawee/importers with the requisite foreign non-judicial import letter of credit and documents are thoroughly examined.
8.	Whether it is ensured that adequate insurance cover is available and kept in force till the bill is retired.
9.	Whether it is verified that the importer's concurrence or rejection is obtained in writing without delay in cases where negotiation by foreign bank is under "Reserve" or "Guarantee".
10.	Whether due date or the fact of Non-acceptance, as the case may be, is promptly advised to the negotiating bank in case of usance bills.
11.	Whether it is ensured that where documents are in order, the drawee is not permitted to refuse the documents.
12.	Whether the balances of outstanding are tallied at least once a month.
13.	Check verification/reconciliation of Nostro and Vostro account transactions/balances, 100% checking of Form A1 & A2 & also of the documents evidencing export.
14.	Whether proper steps are taken in case of dishonoured bills viz., protecting the goods by keeping in warehouse after obtaining margin to cover charges to be incurred by the foreign bank, noting/protesting of the bills obtaining concurrence of ECGC guarantee invoked, and systematically following up the matter of payment with the exporter, RBI and Foreign Bank till the bill is paid or disposed of as permitted by RBI.

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15.	In case of bills remaining outstanding beyond due date, is the branch transferring it to Overdue Head promptly and getting the bills protested and charging overdue interest thereof?
16.	Proper monitoring of advance remittances
17.	Third party remittance of exporters to be scrutinised thoroughly
18.	Manual bills of entry to be verified with custom houses
19.	High sea sales documents to be verified
20.	Multiple sub-threshold transactions in to accounts- cash, RTGS
21.	Immediate withdrawals of money from accounts

5.0 Case Study

- (i) On 11.03.2016 the exporter customer submitted a Bill of Rs.5 crores with all relevant documents to his bank. The Tenor is 90 days' DA from bill of lading. The bill of lading contains the date 05-03-2016 and accordingly the due date is 04-06-2016.
- (ii) On 04-06-2016, the bill remains unpaid. The drawee has requested through the presenting bank 15 days more for payment. Accordingly he should pay on 19-06-2016.
- (iii) The collecting bank of the exporter informs him seeking his instructions. The exporter agrees to give time as requested.
- (iv) The Collecting bank has informed the presenting bank at the other end to hold the same as requested.
- (v) Even thereafter, the drawee does not honour the same on 19-06-2016.
- (vi) Hence, the presenting bank very sternly informs collecting bank that they do not take responsibility for the same there onwards and they will return the documents back. At this point of time, the exporter's bank should inquire with the presenting bank at the other end if "Noting & protesting" has been done by them with the local authorities or not.
- (vii) It is pertinent to note here whether exporter had taken ECGC post-shipment cover. If so, he may be partially compensated for the possible loss. ECGC claim can be entertained only if compliance as per (vi) is done.

Signal No. 3. Delay observed in payment of outstanding dues

Dues could mean –

1. Statutory dues like Excise duty, Service tax, Income tax, TDS, VAT, ESIC, PF, Gratuity etc.
2. Payment to creditors for goods i.e. Stock in trade of the borrower
3. Payment to creditors for expenses like Salaries & Wages, Telephones, Electricity, Rent, Printing & Stationery etc.

‘Outstanding’ means due for payment as per the due date prescribed statutorily or as contractually agreed upon between the Service provider & the recipient.

1. Delays in payment of statutory dues could attract prescribed interest or penalty or sometimes even prosecution in accordance with the statute. Delays in payment of statutory dues clearly implies a liquidity issue which the Bank should verify in detail to be satisfied that the same is temporary & not chronic or permanent to threaten solvency and thus enhancing the default risk putting the bank to possible losses.

Delays in payment of dues beyond a threshold period attract qualification in CARO as per regulation. This qualification is not viewed favorably by Bankers & could affect future fund raising plans of the Borrower. The view is that if a Borrower can delay payment of statutory dues, he can easily delay payment of Bank dues which in no case will be considered favorably.

At times the interest on delays in Statutory payments only attracts interest which could possibly be lower than Borrowing from Market Sources & some Borrowers treat this as a Borrowing from the Government purely from a cost perspective. Again such types of Borrowers are looked on very unfavorably by the Bank.

Banks should be extremely diligent where delays of payment of certain dues like PF, ESIC attract criminal prosecution & the criminal conviction of the Key management personnel could mean a serious business continuity issue.

Banks should monitor the liquidity crisis with due care and understand how the Borrower will meet his liabilities. Assets mortgaged to the bank should be inspected to ensure they are secure and available for liquidation in case of loan default. This is the first Early Warning signal of a liquidity issue turning to a solvency issue threatening Bank realization & should be handled

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proactively immediately ensuring no funds are diverted & used strictly for business purposes.

2. Ideally when a borrower is financed for working capital, amount of creditors for goods is deducted to arrive at the value of paid stocks which is the basis for bank funding. The unpaid dues to creditors will reduce the amount of stocks & reduce the funding of the borrower.

Delays in payment to Creditors may result in –

- (a) Borrower getting Goods at unfavorable, non-competitive rates
- (b) Loss of early payment discounts
- (c) Preference given to Competitors in supply
- (d) Production being stuck due to no supply
- (e) Turnover getting hampered due to non-availability of timely Raw Materials
- (f) Business Continuity could be impacted
- (g) Declining Sales & Margins impacting availability of free cash flows to service bank borrowings leading to loan delays & classification of the Borrower account as NPA which in turn will impact his future borrowings and ultimately growth. This will lead to business stagnation & may possibly lead to business closure. Eventually this will lead to firstly an increase in bank NPA, provisioning affecting the Bank profitability & ultimately Bad debts & write-offs if borrower's condition worsens or denigrates.

Thus, banks should monitor the delays in payments to creditors with seriousness as this is the first Early Warning signal of a liquidity issue turning to a solvency issue threatening Bank realization & should be handled proactively immediately ensuring safety of the Mortgaged stocks as security to be realized by the bank on borrower default.

3. Delays in payment of dues like Telephones, Electricity etc. where there is an external Service Provider with whom there is an agreed repayment due date will attract interest on delays. However, if the delays extend beyond deadline then there is a threat of discontinuance of service which could either cause inconvenience for office electricity or telephone & serious business disruptions in case of factory electricity. Business disruptions could possibly lead to a chain reaction as discussed above which in turn could affect solvency and possibly business closure if not treated promptly & immediately.

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Delays in payment of dues for expenses like Factory or Office Rent could lead to rent adjustments from security deposits kept with the landlord or in delays beyond a period could lead to eviction notices or evictions or non-renewals of lease if due for renewal and the landlord has the eviction – non renewal option. This again would lead to business disruptions & enhanced risks already discussed above.

Delays in payment of Salaries & wages could lead to a staffing, manpower issue due to attrition increasing costs of recruitment, Entity not being able to attract the right talent leading to lack of competitiveness all of which has the potential to lead to solvency risks, business disruptions & the enhanced business continuity & closure risks already discussed above.

Delays in payment of expenses like Printing & Stationery, Professional or Legal fees would affect timely supply of such services, or at times non-supply of services to Professionals could lead to a situation where a new professional incumbent cannot step in unless the earlier professional dues are cleared. This not only affects the borrower's financial credibility, but can also have serious business continuity implications leading to enhanced risks already discussed above.

There is a possibility that the borrower may not be having a liquidity issue and there could be surplus liquidity which he would have invested elsewhere outside business which earn returns and delaying creditors for goods or for certain expenses where he has no supply disruptions and where no interest is to be paid may be profitable to the borrower in terms of margins. Alternately, the liquidity issue could be temporary due to a key Debtor's funds being blocked but which are recoverable. There could also be a case where Investments made could be maturing in a few days which if redeemed now would be at a loss & the cost benefit analysis makes it economically worthwhile not to redeem.

Conclusion – Delays in payment of outstanding dues clearly is an Early Warning Signal of a Liquidity issue. Whether this issue is temporary and is a passing phase or more chronic which may turn in to a solvency issue impacting final recovery of the Bank is what one needs to dive deep into. Depending upon the cause & the likely impact, a Bank needs to pro-actively take steps to secure the assets mortgaged and ensure it does not suffer losses.

Signal No. 4. Frequent devolvement of LCs & invocation of BG's

➤ Introduction

Letters of Credit

Letters of credit (LC's) are a non-fund based limit provided to the borrower. Letters of credit are an important payment mechanism, especially, in international trade. The customers open letters of credit to facilitate import or purchase of goods or capital goods. By means of such letters, the customers take advantage of the credibility of the bank in as much as the exporter or the seller relies upon the promise of a reputed bank instead of the customer. A letter of credit (LC) is an undertaking by a bank to the payee (the supplier of goods and/or services) to pay to him, on behalf of the applicant (the buyer) any amount up to the limit specified in the LC, provided the terms and conditions mentioned in the LC are complied with and the documents specified in the LC are submitted by the payee to the LC opening bank through the medium of a bank

Bank Guarantee

The guarantees are required by the customers of banks for submission to the buyers of their goods/services to guarantee the performance of contractual obligations undertaken by them or satisfactory performance of goods supplied by them, or for submission to certain departments like excise and customs, electricity boards, or to suppliers of goods, etc., in lieu of the stipulated security deposits.

Guarantees are often chosen for cross-border transactions since the beneficiary asserts claims rapidly due to the general nature of the guarantee. A direct guarantee is easier to conform to foreign legal systems and practices due to their not having form requirements.

An indirect guarantee is often issued for export business, especially when government agencies or public entities are beneficiaries. Many countries do not accept foreign banks and guarantors because of legal issues or other form requirements. With an indirect guarantee, a second bank, typically a foreign bank with a head office in the beneficiary's country of domicile, is utilized

The guidelines in this (LC's & BG's) behalf are issued by Reserve Bank of India from time to time. The guidelines are contained in various master circulars / directions issued every year or on continuance basis. These

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facilities constitute non- fund based facilities and disclosed under 'Contingent Liability' in the balance sheet.

As per ICAI Guidance, note on Audit of Banks (2013 edition)

To that extent, the LC arrangement has the latent potential of becoming a fund-based exposure for the bank. To safeguard against such eventualities, banks normally obtain cash margin at the time of opening the LC, which reduces their exposure in the event of devolvement of LC liability on them. The margin may be held in a current account or in term deposit. Banks also obtain guarantees from customers before opening LC. In the case of their established customers, banks sanction LC limits. Whenever an LC is issued, it is recorded in the relevant records and is marked off when the LC is negotiated. The LC limit represents the maximum amount up to which LCs may be outstanding at any point of time. Banks are prohibited from issuing stand-by letter of credit in favour of overseas lenders relating to External Commercial Borrowing (ECBs).

➤ Risk/Fraud Indicators/Source of Information

- Liquidity crunch – Non-fund based limits may be converted into fund-based limits if the borrower is undergoing liquidity issues.
- Fraud by the borrower – If the borrower intends to intentionally defraud the bank by having transactions with a related party, it may invoke BG / result in devolvement of LC, thereby converting non-fund based limits to fund based limit and eventually the borrower may not repay the dues to the bank.
- Inadequate security / margin – While issuing non-fund based limit to the borrower the bank may not take adequate security / margin from the borrower.
- Supplier defrauds the borrower – The supplier may devolve the LC / invoke BG even though he has supplied defective goods or has not supplied any goods. Generally, payment is effected under LC if there is 100% compliance of terms and conditions laid down by LC issuing bank. in case, payment is effected by diluting such terms without proper authorization from the customer or beneficiary, this may result into fraud prone area.
- Parking of such dues in a new account - A number of banks adopt the practice of parking the dues of the borrower in respect of devolved LCs and invoked guarantees in a separate account which is not a regular sanctioned facility. As a result, these are not reflected in the

principal operating account of the borrower. This acts as a hindrance in application of the prudential norms for identification of NPAs. It is, therefore, advised that if the debts arising out of devolvement of LCs or invoked guarantees are parked in a separate account, the balance outstanding in that account also should be treated as a part of the borrower's principal operating account for the purpose of application of prudential norms on income recognition, asset classification and provisioning.

- Frequent devolvement of LC's / BGs – This is an indicator that the borrower is facing huge liquidity issues and the bank may face difficulties in recovering such dues.

➤ **Banks Control – Prevention or Detection**

Before opening LCs / issuing BGs banks should ensure that:

- (a) In order to prevent unaccounted issue of guarantees, as well as fake guarantees, as suggested by IBA, bank guarantees should be issued in serially numbered security forms ;
- (b) Large LCs are issued under two authorised signatures where one of the signatures for LCs should be from the Head Office / Controlling Office. As the need for large LCs may not arise overnight, with the availability of courier service, speed post service etc., this procedure may not result in delay. In the LCs itself a column may be provided to indicate the authority who had sanctioned it together with the particulars thereof;
- (c) Banks should avoid giving unsecured guarantees in large amounts and for medium and long-term periods. They should avoid undue concentration of such unsecured guarantee commitments to particular groups of customers and/or trades.
- (d) LCs are not issued for amounts out of proportion to the borrowers' genuine requirements and these are opened only after ensuring that the borrowers have made adequate arrangements for retiring the bills received under LCs out of their own resources or from the existing borrowing arrangements;
- (e) At the time of issuing financial guarantees, banks should be satisfied that the customer would be in a position to reimburse the bank in case the bank is required to make payment under the guarantee;
- (f) Where LCs are for purchase of raw materials, borrowers do not

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maintain unduly high inventory of raw materials in relation to the norms / past trends. Where such LCs are to be opened on D/A basis, credit on the relative purchase is duly taken into account for the purpose of working out drawing power in cash credit accounts;

- (g) In the case of borrowers having banking arrangements on a consortium basis, the LCs are opened within the sanctioned limit on the basis of the agreed share of each of the banks. Member-banks should not, however, open LCs outside the sanctioned limits without the knowledge of the lead bank / other banks;
- (h) LCs for acquisition of capital goods should be opened only after banks have satisfied themselves about tying up of funds for meeting the relative liability by way of providing for long term funds or term loans from financial institutions / banks;
- (i) Guarantees executed on behalf of any individual constituent, or a group of constituents, should be subject to the prescribed exposure norms.
- (j) It is essential to realise that guarantees contain inherent risks and that it would not be in the bank's interest or in the public interest, generally, to encourage parties to over-extend their commitments and embark upon enterprises solely relying on the easy availability of guarantee facilities
- (k) In the case of performance guarantee, banks should exercise due caution and have sufficient experience with the customer to satisfy themselves that the customer has the necessary experience, capacity and means to perform the obligations under the contract, and is not likely to commit any default.
- (l) In no case, should working capital limits be allowed to be utilised for retiring bills pertaining to acquisition of capital assets.
- (m) The banks must evolve proper guidelines to ensure that, accounts where non- funded limits become "funded" are closely monitored and goods covered under devolved bills remain under bank's control / hypothecation, particularly where foul play is suspected.
- (n) In case of goods covered under import LCs, banks must also ensure immediate submission of custom's copy of the Bill of Entry and take measures as prescribed in the guidelines issued by Foreign Exchange Department

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- (o) There have been a few instances where LCs were opened by officials of banks in an unauthorised manner. In certain cases, the LC transactions were not recorded in the books of the branch by officials issuing them, while in some other cases the amounts of LCs were much in excess of the powers vested in them for the purpose. Subsequently, when the banks come to know about the fraudulent issue of LCs, they disclaim liability on the ground that these are transactions involving a conspiracy / collusion between the beneficiary and the constituent.
- (p) It may be appreciated that if the bills drawn under LCs are not honoured, it will adversely affect the character of LCs and the relative bills as an accepted means of payment. This could also affect the credibility of the entire payment mechanism through banks and affect the image of the banks. It is, therefore, necessary that all the banks should honour their commitments under LCs and make payments promptly leaving no opportunity for any complaints in this regard. Needless to say, banks should take suitable action against the concerned officials as well as the constituents on whose behalf the LCs are opened and the beneficiaries of LCs, if a criminal conspiracy is involved.

➤ **Audit Process**

- (a) The auditor should verify whether there exists a system whereby the non-fund based facilities to parties are extended only to their regular constituents, etc.
- (b) Ascertain whether there are adequate internal controls to ensure that issuance of LCs / BGs giving rise to contingent liabilities are executed only by persons authorized to do so and in accordance with the laid down procedures.
- (c) The auditor should also examine whether in case of LCs for import of goods, as required by the above-mentioned Master Circular on guarantees and co-acceptances, the payment to the overseas suppliers is made on the basis of shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs.
- (d) The auditor shall also verify that the amounts pertaining to invoked BGs and devolved LC's are not parked in a different account so as to escape the IRAC norms.

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- (e) The auditor should extract a report of all the devolved LC's and invoked BG's and then scrutinize the same to the customer level to verify whether there is frequent devolvement in a particular borrower's case.
- (f) In case of guarantees issued on behalf of the bank's directors, the bank has taken appropriate steps to ensure that adequate and effective arrangements have been made so that the commitments would be met out of the party's own resources and that the bank will not be called upon to grant any loan or advances to meet the liability consequent upon the invocation of the said guarantee(s) and that no violation of section 20 of the Banking Regulations Act, 1949 has arisen on account of such guarantee.
- (g) The auditor should also examine whether the bank has given any guarantees in respect of any trade credit (buyer's credit or seller's credit). The period of guarantees is co-terminus with the period of credit reckoned from the date of shipment.
- (h) Verify whether bank has extended any non-fund facility or additional/ad hoc credit facilities to other than its regular customers. In such cases, auditor should examine the existence of concurrence of existing bankers of such borrowers and enquire regarding financial position of those customers.
- (i) The auditor should ascertain whether there are adequate controls over unused guarantee forms, e.g., whether these are kept under the custody of a responsible official, whether a proper record is kept of forms issued, whether stock of forms are periodically verified and reconciled with the book records, etc.
- (j) The auditor should evaluate the adequacy of internal controls over issuance of letters of credit and over custody of unused LC forms in the same manner as in the case of guarantees.

➤ **Case Study**

XYZ limited and ABC limited are related parties. XYZ Limited wants to purchase material worth Rs. 1, 00, 00,000 from ABC Limited on Letter of Credit basis for 365 days' credit period.

Sequence of events:

- A. In this case, XYZ, through its employee, requests the bank manager for opening of Letter of Credit facility of Rs. 1 Crore in its favour.

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- B. The Bank opens the Letter of Credit of Rs. 1 Crore and thereafter debits XYZ account with bank charges and XYZ may now enter into a contract with ABC to procure raw material on a credit period of 365 days.
- C. After the Letter of Credit is opened, XYZ makes only a book entry of the purchase transaction with ABC limited. In effect there is no movement of goods.
- D. ABC issues the invoice to XYZ and then further discount the LC issued by XYZ's bank with some other bank. The other bank deducts the 365 days' interest cost and relevant processing charges from the LC amount (Rs. 1 Crore) and transfers the balance to ABC.
- E. Post receipt of the amount, ABC remits the amount to XYZ which, in turn diverts the funds to meet its real estate project requirement. Hence, the non-fund based limit has been converted to fund based limit by virtue of this transaction.

From the above transaction it is clear that the transaction was undertaken only with an ulterior motive of diversion of funds. When such activities take place on a repetitive basis then it may happen that XYZ Limited is unable to service the debt and eventually the account may become a non-performing asset.

Signal No. 5. Under insured or over insured inventory

Introduction

Inventory is goods / materials which are held by company before selling them to end users.

Inventory is usually classified as an asset on the balance sheet, following receivables. It can be classified as raw materials, Consumables, Packing material, Work in Progress and Finished Goods. Inventory reflect costs directly or indirectly incurred in making an item ready for sale, including the purchase price of the item as well as other cost such as freight, unpacking, inspecting charges, storage Expenses, insurance, taxes etc. incurred to bring the inventory in present position and location.

Banks are extending various types of Loans against inventory. The most common form of extending credit is by way of Working Capital Limit against Stock /Debtors and Packing Credit.

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To provide such loans, Lending banks carry out detailed analysis of the borrowers' working capital requirements and then fix the credit limits as per their internal policy guidelines.

Risk/Fraud Indicators/Source of Information

Some Common Fraud Risks in inventory are as under

(a) Theft of physical assets: One common risk is thefts of inventory items. Since inventory items can be numerous, of small value, readily accessible and removable, if they are not well protected, they are subject to theft. The material represented by book is not actually available at the location.

(b) Alteration / Manipulation of records: In this case, Loss in books is reduced by manipulating the inventory records.

(c) Recording false sales: There are two legs of a sales transaction record: the money coming in and the inventory going out. In false sale fraud – as there is no sale to record – only the inventory going out is recorded. As the levels of inventory are reduced to reflect the stolen item being sold, it can simply be taken without being missed in a stock-take. As the value of sale has not been recorded, no money is expected to be collected.

(d) Recording false Purchase: False purchase fraud is based on the theft of inventory purchased before it is recorded in the perpetual system. The main part of the fraud is to record the financial side of the purchase so the supplier gets paid, but not record the receipt of the items in the stock records. The 'paperwork' is separated into the two parts of the transaction. According to inventory records, the item is never received. It is removed from site or collected from the outside physical store location. Fraud is completed when the invoice from the supplier for the items is paid. The documentation from the supplier is valid.

(e) Mixing of related party Stock: group company / Associate concern inventory is shown as inventory of main company.

(f) Mixing of Bad / obsolete items with good inventory: Company will show the old or non-usable items as good items in the inventory list leading to overvalued inventory.

Bank's Control – Prevention or Detection

Since bank has extended finance against inventory, Bank needs to monitor the adequacy of available security in the form of inventory. Some of the common controls are as under:

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- Annual Stock audit by External Auditors
- Periodical inspection by bank officials / Concurrent Auditors
- Insurance of Stock
- Obtaining and check periodic Operational and Financial data
- Obtaining periodical Stock statements.
- DP is calculated and properly fed in the system.

Audit Process

Audit Process would involve Planning, Documentary review, Physical verification and reporting

PLANNING

In planning, one should get the following information:

- Location and nature of Items stored
- System of accounting and software in use
- Method of valuation of Stock
- Method of physical verification adopted by company
- Method of adjustment in stock such as return and write off
- Method of calculation and updation of DP in system

DOCUMENTARY REVIEW

As explained above, the bank obtains financial and non-financial information on various aspects of inventory. Auditor should check the following:

- Ratio of sale and inventory
- Average inventory held
- Sudden increase in inventory
- Nonmoving items if any
- No change in Quantity but only value is changed periodically to match the DP
- Compare the insurance value and stock Valuation
- Compare the audited stock with the stock statement submitted and justification for variation

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PHYSICAL INSPECTION

As explained above, one of the controls is visit to factory premises / warehouse.

During physical inspection Auditor should check the following:

- Quality of storage arrangement
- Condition of Stock
- Updation of inventory records
- Display of Banks Board
- Control on movement of material
- Checking of sample items
- Understanding Maximum storage capacity

Signal No. 6. Invoices devoid of TAN and other details

TAN or Tax deduction & collection account number is a 10 digit Alpha-numeric number issued to persons who are required to deduct or collect tax on payments made by them under the Income Tax Act, 1961. TAN is to be obtained by all persons who are responsible for deducting tax at Source (TDS) who are required to collect Tax at source (TCS). All assesses liable to deduct TDS are required to apply for TAN & quote this number in all TDS returns, payments, certificates & all communications regarding TDS with the Income Tax Department.

Sec 203 of the Income Tax Act, 1961 mandates that all assesses liable to deduct TDS shall quote TAN in all communications regarding TDS with the Income Tax Department. Failure to do so attracts a penalty of Rs 10,000/- . TDS receipts & payments will not be accepted by banks if the TAN is not quoted. TAN enables assesses who have received the payments to claim their Tax deducted at source in their income Tax return.

TIN – Tax Identification Number is an 11 digit number allotted to Tax payers registered under VAT for sale of goods & services. TIN is to be quoted by all business enterprises for sale transactions similar to how PAN is to be quoted for all tax transactions handled. TIN is issued by the Commercial Tax Dept. of the State for tracking all VAT related activities. All assesses i.e. – Manufacturers, Sellers & Exporters are required to pay VAT should have a TIN & quote it on every VAT related Transaction. VAT is to be paid to the respective State Governments at the rate prescribed for the respective product sold.

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Excise duty is paid by manufacturers at rates prescribed if the manufactured turnover exceeds the prescribed threshold.

Service Tax Number is a unique 15 digit number which is required for payment & filing of Service Tax returns. It is mandatory for all service providers to apply for a Service Tax number if the value of services provided in a financial year exceeds Rs 9 lakhs which is the current threshold prescribed for application. Service Tax Number is a 15 digit Number of which the first 10 digits are the same as the PAN of the Service provider. Service Tax has to be charged at the prescribed rates & is payable to the Government as prescribed.

Risk / Fraud Indicators

A Bank borrower may either avail a Cash credit, Overdraft, Loan facility or an Invoice discounting facility. The borrower may either be a Manufacturer, Seller or a Service provider. In case he is a Manufacturer - Seller, he will need to pay Excise duty / VAT at prescribed rates if his turnover exceeds the prescribed threshold. Similarly, if he is a service provider he may need to pay service tax at prescribed rates if the value of services exceeds prescribed threshold in a financial year. Similarly a seller will need to pay VAT. Tax will be deducted at source on expenses at prescribed rates over prescribed thresholds. Income Tax will be payable on the profits chargeable to Tax under the Income Tax Act, 1961 at prescribed rates for different categories of assesseees.

For a Borrower, availing Cash Credit -Working Capital facility, Draw Power is computed by arriving at the Value of paid stocks and debtors after deducting prescribed margins as per the terms of the Sanction Letter issued by the Bank to the Borrower. Thus, for determining Draw Power accurately to arrive at the eligible funding, the Valuation of Stocks, Debtors & Creditors is the key. This valuation can only be arrived at as per the value of the Invoices billed between the Seller & the Purchaser either who can be the Bank Borrower depending upon the facts. Thus a tax Invoice is the real substance behind the transaction that arrives at the Value of Stocks, Debtors & Creditors.

Invoices devoid of PAN / TAN / TIN / Service Tax number raise doubts about the genuineness which in turn impacts the genuineness of the Draw Power & the eligibility of the bank funding to the Borrower.

Banks Control – Prevention or Detection

Banks should be careful of possibilities of Fund diversion, Money laundering,

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Creation of a fictitious asset, Creation of an asset much below or without the stated invoice value.

This exposes the bank to a higher Credit risk & the possibility of credit losses in the event of a loan default as the underlying security may possibly not exist or be valued much below the loan amount due.

Banks should note that if this is done with a deliberate intent to entitle the borrower to a facility or availing funds which he would not have been entitled otherwise (with or without connivance) or (with or without the support tacit or otherwise) of the supplier / buyer as the case may be, had the statutory & legal procedures or the Bank procedures & policies been followed, this would tantamount to a FRAUD or an attempted Fraud. This would require compliance with the requirements as given in the RBI Master Circular on Frauds.

Banks should also verify whether the Borrower has also paid his Service Tax, Excise, Income Tax or VAT dues if & wherever applicable timely. Non-charging of such taxes by Bank Borrowers to their buyers / Clients clearly implies Tax Evasion & banks should desist from financing such transactions.

Banks should clearly be careful & verify invoices which are being funded by them either raised by their borrower or their buyer / supplier.

Audit Process & Case Studies / Illustrations

1. The Bank Borrower has applied for a Term loan to purchase Machinery & tendered an Invoice of the supplier which does not have the TIN. In this case the Bank needs to be careful about the transaction considering the amount involved if it exceeds the minimum threshold amount prescribed by the concerned state where the Sale has happened, over which VAT is payable by a seller. In this case, there is a possibility that the transaction may not be reported to the Tax authorities & tax would be evaded. Ideally, the Bank should desist from being a party to financing such a transaction. The Borrower has to satisfy the bank by documented evidence that there is no tax evasion in this case. Alternatively, if the isolated Invoice value is below the threshold prescribed by the State for attraction of VAT, then the Bank should still satisfy of other Turnover of the supplier to ensure no taxes are evaded. In either case, bank should verify whether there is an actual Sale taking place, there is delivery of the machinery to the Borrower who has installed the same in his Factory premises and put it to use for business purposes as stated in the Loan application. Bank

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should also be satisfied about the cost and value of the Machinery and that it is in sync with the Invoice raised.

2. Borrower may have claimed expenses & furnished invoices devoid of Service Tax number for financing his Working Capital CC - OD or Loan limits. In this case also the bank should verify whether the Invoice in question in isolation exceeds the Government prescribed value that attracts Service tax. If the Invoice value exceeds that amount, then Bank should desist from being a party to the transaction where Taxes are being avoided. Alternatively if the Invoice value in isolation is below the threshold amount, bank should satisfy whether there are other services rendered by the Service Provider & the threshold amount is exceeded. Thus the Bank should be satisfied that the transaction funded does not lead to any evasion of Taxes & there is an actual rendering of service and the transaction is not a book entry to make the borrower eligible to get a funding which he is not entitled to.
3. The Bank Borrower may have applied for a Vehicle Loan & the invoice rendered in support of the transaction does not have a TIN. Thus, in this case though there may be an actual supply of a Motor car & the exchanged value would be fair & happening in substance, Banks should ideally desist from financing this transaction since the Supplier is clearly avoiding Taxes in this case.
4. Banks should similarly desist from making payments for Bills Purchased or Invoices Discounted devoid of TIN / TAN / PAN / Service Tax Number.

Alternatively, there may be a possibility that these transactions devoid of TIN / TAN / PAN or Service Tax number on the Invoices which is the underlying substance of the transaction value may be book entries without any economic rationale behind the actual monetary flow exchange between the buyer & the seller of the Service Provider & the recipient as the case maybe.

Conclusion – Banks should undertake extra due diligence if they come across Invoices devoid of TAN / TIN / PAN / Service Tax number. This is an Early warning Signal or a red Flag for further deep dive or enquiry in- to the transaction. Ideally, they should desist from funding transactions in absence of these numbers, unless they are clearly satisfied that the transaction is genuine, there is no evasion of taxes, there is an underlying economic transaction of the value reflected, there is a money flow between the 2 parties & the underlying asset / service has been verified to ensure there is no fictitious lending.

Signal No. 7. Funding of Interest by sanctioning additional facilities.

➤ **Introduction**

Funding of interest by sanctioning additional facilities may be carried out by the bank when the borrower is unable to service his present interest dues to the bank; in other words, it is a stressed account. In such cases, the bank may offer the borrower a restructured package wherein it offers additional credit facilities to the borrower so as to enable him to tide over the liquidity crunch and also to cater to the borrowers' present working capital needs.

However, in some cases one of the objective(s) of banks in sanctioning additional loans / credit facilities may be to retain the current classification of the borrower account which generally is classified under the standard category by offering such additional credit facilities and also to prevent the borrowers' account from turning into a non-performing asset.

➤ **Risk/Fraud Indicators/Source of Information**

- Incorrect credit appraisal – The borrower may be drawing more credit facilities than his eligibility as computed under Maximum Permissible Banking Finance.
- Inadequate security cover – No new security may be provided by the borrower as a collateral to secure the additional credit facilities.
- Diversion of Funds: - The funds sanctioned earlier were utilized for the purpose other than specified, hence client is facing liquidity problem in servicing the interest.
- Diversion of Funds – Additional funds sanctioned may be utilized for some other non-bona- fide purposes. In other words, there is diversion of funds.
- Unviable Project – Inability of the borrower to pay its interest dues may indicate non-viability of the project it has undertaken.
- Risk of default of additional credit facility – The borrower may not be able to revive the project / business in spite of availing the additional credit facilities and may also default on the additional credit facilities granted to him.

➤ **Banks' Control – Prevention or detection**

The bank should obtain additional securities from the borrower prior to sanctioning him additional credit facilities. Further, the Bank has to decide

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the stress accounts which require special attention and monitoring at all levels including branch region and head office. Reserve Bank of India (RBI) has issued guidelines recently to indicate such accounts in RBI Circular RBI/2015-16/422 DBR.No.BP.BC.103/21.04.132/2015-16 dated June 13, 2016 regarding 'Scheme for Sustainable Structuring of Stressed Assets'.

These accounts may be downgraded if the borrower fails to adhere to terms and conditions while granting him additional facilities and any deviation(s) may result into eventual credit default by the borrower. It would also indicate weakness in credit appraisal of the account.

In such cases the bank should ensure that there should not be further dilution in security and business performance should be corroborated with future projections so as to generate sufficient funds for repayment of interest and principal amount of term loan/ working capital/ FITL.

➤ **Audit Process**

The auditors should follow the following checklist as minimum compliance while auditing such accounts:

- Scrutinize and verify the sanction letter so as to ascertain the purpose for which such additional facilities are sanctioned
- Detailed study of appraisal note/ memorandum/process note to verify whether the reasons for stress on liquidity are ascertained.
- Verify with the authority matrix, whether the additional credit facilities have been sanctioned by the appropriate credit officer
- Verify if the bank has obtained on record the end-use certificate from an independent CA and also whether the bank official has himself performed appropriate procedures to verify the end use of funds.
- Verify whether such additional facilities are being regularly monitored by the respective branch or the regional offices or the Head office.
- Verify the operations in the account so as to ensure that the funds are not being siphoned off by the borrower and no suspicious transactions are observed in the account
- Verify whether all the terms of the sanction letter for the additional facilities has been adhered to by the borrower.

➤ **Case Study**

A manufacturing entity has been financed by the bank on the basis of projected cash flows in December 2010. The entity was given sanction basis

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- repayment in three years. However, the entity could not generate sufficient funds to repay the bank dues. On this background and with the borrowers' request the account was restructured and was granted additional facility of Rs. 135 Lakhs for reimbursement of expenses pertaining only to fixed assets.

After going through the account statement and the sanction order issued to the borrower in December 2014, following points were observed:

- (a) The entity applied for a term loan (additional facility) for reimbursement of expense for acquisition of fixed assets which will help them bring in requisite cash flows.
- (b) The entity was increasing investment in fixed assets without ascertaining its economic viability, further the same was also not verified by the bank.
- (c) The entire funds sanctioned under term loan amounting to Rs. 135 L (inclusive of processing fees) were utilized to serve the arrears of its existing Term Loan/ CC Account.
- (d) The proceeds were utilized in serving the arrears in the following manner:

Sr. No.	Before Disbursal Balance as on 31.12.2014	Disbursal of new loan on 31.12.2014	Interest charged as on 31.12.2014	Op. Bal. as on 01.01.2015
	A	B	C	D= A+B+C
1	1,96,67,443.00	9,09,564.00	2,31,265.00	1,89,89,144.00
2	10,92,01,455.00	90,00,000.00	12,99,778.00	10,15,01,233
3	8,78,76,871.00	32,02,000.00	10,36,948.00	8,57,11,819.00
4	7,06,256.00	2,36,750.00	7,382.00	4,76,888.00
5	-	(1,33,48,314.00)	-	1,33,48,314
	21,74,52,025.00	-	25,75,373.00	22,00,27,398.00

- (e) The current account of the borrower with the Bank also does not have any credits.
- (f) It is evident from the above table that the funds were not utilized for reimbursement of capital expenditure, but for recovery of over dues in the existing facilities availed by the borrower.

Hence, in effect this has resulted in postponement in classification of performing asset into a non-performing asset.

Signal No. 8. Frequent request for general purpose loans

Introduction

Generally, a Borrower will either have an Overdraft, Cash Credit, and Demand Loan, Term Loan or a Bill Discounting facility.

Term Loans could be for purchase of a vehicle or a House or Funding Education.

Overdrafts could be against security of Property, Bank Fixed deposits, Mutual Fund Units, Equity shares or any other marketable financial security.

Banks sanction loans for a fixed tenor or overdraft or cash credit limits renewable yearly. Technically, all Loans are repayable on demand on default of clearly laid down & accepted sanctioned terms & conditions.

Banking facilities or Lines of Credit or Limits are sanctioned after a due credit appraisal process considering past audited financials & future business projections. The facilities could be fully or partly secured, guaranteed by other banks, secured by mere comfort letters or could be unsecured.

Bank Credit Policy within overall directions of RBI as detailed in various circulars issued by RBI from time to time lay the direction for appraisal & sanction of funding limits.

Risk / Fraud Indicators

Issues that a bank faces is when the Borrower is not able to repay the Overdraft or the Loan installment either due to incorrect estimation of the working capital gap or conditions of estimating repayments from customers / realizations from sale of assets / internal borrowings etc. could not be met.

Borrowers try to get their regular limits enhanced so that the overdrawn TOD/ General purpose Loan becomes a part of normal limits. This would be permissible if current circumstances warrant the enhanced funding or the initial funding was conservative and the current funding justifies the level of Stocks / Debtors / Creditors as of date.

The worry is when the requests for these General purpose loans or Overdrafts become a regular, recurring or a frequent feature. This would imply –

- (1) Grossly incorrect requirement of Working capital limits asked for by the Borrower from the bank

Early Signals of Fraud in Banking Sector

- (2) Grossly inaccurate assessments of the working capital Limits by the bank & sanction at a significant hair cut to that asked for purely out of conservatism –
- (3) Liquidity issue of the Borrower – either due to Poor sales or over-trading or Collections, shortage of raw materials, inability to get raw materials at a competitive price on favorable terms of credit, poor financial credibility & market standing of the Borrower.
- (4) Inability of the Borrower to raise funds from internal sources i.e. his friends and relatives and internal accruals. This also implies that the borrower has no back-up emergency funding plans.
- (5) Borrowings done to prevent an account from being classified as an NPA.

Bank Controls – Prevention & Detection

Banks have to make provisions for non-performing assets and de-recognize income on such assets if not received as per laid down norms.

Classification of a loan account as NPA & consequential provisioning thereof is not looked favorably by Banks as it impacts their bottom line & also leads to increase in Gross NPA ratios.

Banks proactively monitor recoveries from loan accounts to ensure that these accounts do not turn NPA's.

Frequent requests generally more than 3 times a year and not repaid as per agreed upon terms is viewed as credit indiscipline by the Bank. This would also impact Borrower scoring, levy of interest & his future funding.

Audit Process

Banks need to be diligent when they receive frequent requests for General Purpose loans. They need to satisfy themselves of the genuine need for these loans. They need to ascertain the root cause of this request and take long term corrective steps to set right the issue so that the Borrower does not come over for repeated requests. This could mean a fresh appraisal of working capital limits to arrive at a realistic fund requirement which can be financed on modified terms & securities mortgaged. Again such funding should be need-based and a 1 off temporary case due to unavoidable issues.

Frequent requests imply that the underlying risk is not correctly assessed & this needs fresh assessment of the facility with the security.

This could possibly be viewed as restructuring, reschedulement, window-dressing or even greening based on facts & circumstances of the case if the intent is to purely avoid NPA classifications.

Case Study / Illustrations

From the perspective of the Borrower, banks have funded him for Working capital by way of cash credit to meet the funding gap between receipt of raw materials & their payment to the production, sale & eventual receipt of money from customers.

In case this Demand-Supply Chain is disturbed by delay in receipt of payment from 1 customer, the Borrower will face a liquidity issue and will have to raise funds through internal sources for meeting his commitments to suppliers, statutory payments to Government by way of taxes & payments to suppliers of services or Employee payments. In case the Borrower is not able to generate funds through his internal savings or borrowings from his friends or relatives or from market sources either he will default in his obligations either to the Bank or to the Government or to his suppliers of Goods or Services. In the alternate, the Borrower will also approach the bank to give him a Temporary Overdraft for a few days or months or a General purpose Loan typically for a period from 6 months to a year to tide over his temporary liquidity issue. The bank will verify the circumstances and if it feels that there is a genuine temporary need, sanction him the Overdraft / Loan to meet the obligations.

Conclusion

Banks should handle cases of frequent requests of general Purpose Loans with due care. The root cause or the reason for the frequent Loan request should be ascertained & the Borrower should be asked to set it right. Real risk of liquidity threatening to become Solvency and Business Continuity needs to be plugged at inception.

This is an early warning signal implying incorrect assessment of working capital limits or borrower liquidity crisis. In either case, bank needs to proactively monitor the issue and take control of the security mortgaged to it for necessary realization on loan default. Action has to be need- based on accurate estimates of the future business based on current scenario.

Signal No. 9. Frequent Ad Hoc Sanctions

Introduction

Ad hoc or Temporary Limit:

Ad-hoc limit is the limit fixed by the bankers for existing borrowers in the following cases:

- (i) Sudden Bulk order results in additional working capital requirement.
- (ii) The proposal of the working capital is either in the process of enhancement or renewal.
- (iii) In any other case which the bank thinks is suitable justification for sanction of ad hoc limit.

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

Risk/Fraud Indicators/Source of Information

Following are the risks related to frequent sanction of ad-hoc loans.

- Diversion of Funds – Funds released by ad-hoc loans were not used for the intended purpose
- Cost Escalation – Cost of project may overshoot the planned budget
- Inadequate security – No new security was provided for ad-hoc sanction resulting in short realization in case of default
- Inefficient Fund management – Frequent ad-hoc sanction of loans indicates that the company is not able to manage its working capital properly as per the assessed sanction limit.
- Irregular account – There is a possibility that the borrower is unable to repay the ad hoc portion and consequently the account may become irregular.

Bank's Control – Prevention or Detection

Bank is exercising following control for ad hoc sanction

- Time limit for adjustment : Policies are framed by banks wherein it is specified that Ad hoc limit regularized not later than three months from the date of ad-hoc sanction
- Approval by higher authorities: Policies are framed by banks wherein it is specified that Ad hoc limit can be sanctioned by specified authorities up to a certain limits.

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- Reporting: Specific information on ad hoc is obtained from branch as well as from auditors on performance of borrower in case of ad hoc limits.
- Additional Securities: Additional securities are obtained from borrower before release of ad hoc limits.

Audit Process

Following are the check points for verification of ad hoc sanction

- Verify the purpose of ad hoc sanction as per the request letter given by borrower.
- Check seasonal increase is supported by audited financials of earlier years.
- Check the increase in limit is rational considering the present industry trends
- Check sanction is given by the specified authorities as per the credit policy before disbursement.
- Check the limit is released after proper documentation and security creation as per the terms of sanction.
- Check the end use of funds by checking transaction in system or by taking end-use certificate from independent chartered accountant.
- Check that limit is regularized within time.
- Check there are ad hoc are not given frequently and note the time gap between adjustment and release of fresh sanction.

Signal No. 10. Heavy cash withdrawal in loan accounts

Introduction

Bank is extending various types of loans to borrowers as per the requirement. One of the most common loans is Working capital (WC) loan for the ongoing business requirements. They can further be classified as WC Demand loan, WC term loan, Factoring, WC Loan against Debtors etc.

In all such loans, the basic purpose is to fund the daily operating cycle of the business. Depending on the type of industry, some of the transactions in the cycles are done in cash.

Risk/Fraud Indicators/Source of Information

Large withdrawals in cash - Cash is periodically withdrawn either in small amounts at regulars interval or in large amounts occasionally.

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Source of information

Cash withdrawal can be verified with

- a) Statement of accounts
- b) CTR (cash transaction report) generated from CBS
- c) Daily cash Scroll Report
- d) Cash Book
- e) Exceptional Transaction Report

Bank's Control – Prevention or Detection

Some of the controls by banks can be summarized as under:

Preventive	Detective
Limit on amount of Cash withdrawal Prior permission / sanction of cash withdrawal in estimation of working capital	Send System generated alert to borrower Reporting by Concurrent auditors

Audit Process

To start with, First auditor should obtain Transaction report of cash withdrawal from one of the source as mentioned above.

The data can be imported in Excel from the Text format. The data can be summarized as date wise / Month wise cash withdrawal. Calculate average monthly transactions.

Check the KYC submitted by Borrower to confirm the nature of Business. Even though the transactions are in cash ,considering the inherent nature of Business it can be a genuine business transaction such as petrol pump, Retail vendors, Mining, etc.

Compare the monthly average with previous year data.

Obtain bank account details of related parties/ Associate companies. Check the transaction in these accounts. Sometimes it is quite possible that cash is withdrawn from new loan and cash are deposited in other associate companies to avoid the account becoming irregular.

Check other business indicators, such as growth in sales, growth in profit etc. Sometimes, cash is withdrawn to support the additional working capital requirement due to increased working capital cycle.

If none of the above factors supports the withdrawals, then cash book of the borrower can be obtained for nature of Expenses and if possible proper justification by borrower.

Signal No. 11. Significant increase in working capital borrowing as percentage of turnover

(a) Introduction

The working capital borrowing limits of each borrower is based on the CMA data provided by the borrower to the Bank. According to his past audited and future estimated turnover, profits and the gaps in the working capitals, the banks plan the working capital limits of the borrower. It is mainly the turnover - actual and the estimated - that drives the working capital estimations for the borrower. Higher the turnover higher would be the requirement of the working capital to fund the business activities and vice versa.

(b) Risk/Fraud Indicators/Source of Information

There is always a risk associated with this area since there are high possibilities that the actual figures might not be in line with the estimates given by the borrower at the time of the review/ renewal/ sanction of his working capital limits. The turnover may vary based on the industry trends, global and domestic market scenario and the economic environment overall.

It is frequently observed amongst banks that whenever there is sudden increase in the business activities of the borrower during the year and there is still time for the account to be renewed/ reviewed then in such instances usually the increased funding limits are met by the banks through sanctioning of ad hoc limits. Similarly, if there is decline in the business but the working capital limits are still at the same level, then there are risks that the excess liquidity enjoyed by the borrower may be diverted to some other areas since his business activities do not need the same working capital with a downfall in the turnover.

In such cases, there would be fewer transactions in the accounts and the money and the borrower would face difficulties in servicing the interest. The main fraud indicators in such instances may be derived from the stock and receivables statements submitted by the borrower on a monthly basis and the quarterly and half yearly reports. From this report, it can be ascertained whether there has been substantial increase in the debtors or the stock levels, the investment levels, investments in fixed assets, short-term funds used for long-term purposes etc. In particular, the related party debtor balances should be checked to ascertain the diversion of funds.

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The annual audited reports of the borrower serve a purposeful source of information to determine the financial status and determine the appropriate working capital limits of the borrower.

(c) Bank's Control – Prevention or Detection

The Bank has to exercise appropriate controls in such cases by implementing the debit and credit summation flags in the system based on the working capital limits of the borrower. Whenever the transactions decline the system should raise red flags in such accounts and mention these accounts in the exception reports for the attention of the Branch/ auditors and the higher authorities.

When the turnover of the borrower drops substantially and there are lower transactions in the account then the Bank should assess the requirements of the party and decrease his working capital limits to safeguard its interests.

The Bank can prevent frauds through unit inspections of the borrower units and scrutinizing the stock and receivable statements and then relate the same with the transactions in the accounts.

(d) Audit Process

The auditor has to scrutinize the ledger, check the stock and receivable statements, the quarterly/ half yearly reports/ annual audited reports/ stock audit reports/ unit inspection reports/ exception reports and check whether the funds have been diverted by the borrower when the business has declined and the working capital limits have been the same.

(e) Case Study

Borrower ABC Private Limited was manufacturing steel pipes and major of the production was being exported to the United States of America (USA). He was enjoying funded and non-funded limits of Rs. 25 crores under sole banking.

In one of the years, USA, to protect its domestic manufacturers, levied anti-dumping duty on the products and thus ABC's products became unviable for the USA markets and the turnover of the company declined substantially. Due to lower sales, gradually the transactions in the accounts with the bank decreased. Being a listed company and to maintain its market share, ABC started investing the working capital in the capital markets with an aim to earn early profits and wipe off the business losses. It started investing heavily in the stock markets.

The account was red flagged by the system of the Bank and the Branch

Operations of Account

started enquiring regarding the huge payments being made to the stock brokers. The Branch Manager in consultation with his higher authorities immediately visited the unit of the party and checked the stock records and appointed a stock auditor. Based on the stock auditors' report, the Bank could ascertain the decline in the business and the lower stock and debtors levels and thus prevented the account from turning into NPA by restricting the withdrawals from the account and reducing the working capital limits of the borrower gradually.

Section 2

Concealment or Falsification of Documents

Signal No. 12. In Merchanting trade, import leg not revealed to the bank

Introduction

In simple terms, Merchanting transaction is one which involves shipment of goods from one foreign country to another foreign country involving an Indian Intermediary. Hence, it is also called Intermediary Trade. The merchant or the intermediary will be resident in India.

As per RBI/2013-14/545 A.P. (DIR Series) Circular No.115 dated March 28, 2014; the following are the key components of the same:

- (i) for a trade to be classified as merchanting trade, following conditions should be satisfied;
 - Goods acquired should not enter the Domestic Tariff Area and
 - The state of the goods should not undergo any transformation.
- (ii) Goods involved in the merchanting trade transactions would be the ones that are permitted for exports / imports under the prevailing Foreign Trade Policy (FTP) of India, as on the date of shipment and all the rules, regulations and directions applicable to exports (except Export Declaration Form) and imports (except Bill of Entry), are complied with for the export leg and import leg respectively.
- (iii) AD bank should be satisfied with the bonafides of the transactions. Further, KYC and AML guidelines should be observed by the AD bank while handling such transactions.
- (iv) Both the legs of a merchanting trade transaction are routed through the same AD bank. The bank should verify the documents like invoice, packing list, transport documents and insurance documents (if originals are not available, Non-negotiable copies duly authenticated by the bank handling documents may be taken) and satisfy itself about the genuineness of the trade.

Concealment or Falsification of Documents

- (v) All the merchanting trade transactions should be completed within an overall period of nine months and there should not be any outlay of foreign exchange beyond four months.
- (vi) The commencement of merchanting trade would be the date of shipment / export leg receipt or import leg payment, whichever is first. The completion date would be the date of shipment / export leg receipt or import leg payment, whichever is the last.
- (vii) Short-term credit either by way of suppliers' credit or buyers' credit will be available for merchanting trade transactions, to the extent not backed by advance remittance for the export leg, including the discounting of export leg LC by an AD bank, as in the case of import transactions.
- (viii) In case advance against the export leg is received by the merchanting trader, AD bank should ensure that the same is earmarked for making payment for the respective import leg. However, AD bank may allow short-term deployment of such funds for the intervening period in an interest bearing account.
- (ix) Merchanting traders may be allowed to make advance payment for the import leg on demand made by the overseas seller. In case where inward remittance from the overseas buyer is not received before the outward remittance to the overseas supplier, AD bank may handle such transactions by providing facility based on commercial judgement. It may, however, be ensured that any such advance payment for the import leg beyond USD 200,000/- per transaction, should be paid against bank guarantee / LC from an international bank of repute except in cases and to the extent where payment for export leg has been received in advance;
- (x) Letter of credit to the supplier is permitted against confirmed export order keeping in view the outlay and completion of the transaction within nine months.
- (xi) Payment for import leg may also be allowed to be made out of the balances in Exchange Earners Foreign Currency Account (EEFC) of the merchant trader.
- (xii) AD bank should ensure one-to-one matching in case of each merchanting trade transaction and report defaults in any leg by the traders to the concerned Regional Office of RBI, on half yearly basis in

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the format as annexed, within 15 days from the close of each half year, i.e. June and December.

- (xiii) The names of defaulting merchanting traders, where outstandings reach 5% of their annual export earnings, would be caution-listed.
- (xiv) The merchanting traders have to be genuine traders of goods and not mere financial intermediaries. Confirmed orders have to be received by them from the overseas buyers. AD banks should satisfy themselves about the capabilities of the merchanting trader to perform the obligations under the order. The overall merchanting trade should result in reasonable profits to the merchanting trader.

As per the Master Circular on imports, the provisions of Uniform Customs and Practices for Documentary Credits have to be adhered to while opening letters of credit for import into India. The Uniform Customs and Practices for Documentary Credits-600 (UCP 600) issued by the International Chamber of Commerce Commission on Banking Technique and Practice, effective from 1st July 2007 is the latest version.

Risk/Fraud Indicators/Source of Information

The key risk / fraud indicators may be summarized as under:

- (i) Inadequate documentation to support the bonafides of the transactions. Non-adherence to the KYC and AML guidelines. Inadequate / no information on the public domain with regard to the parties involved in the transactions.
- (ii) Not obtaining proper credit reports on these parties from reputed agencies.
- (iii) Non-availability of packing list, transport documents and insurance documents either in originals or copies duly authenticated by the bank handling documents.
- (iv) Export of goods on credit basis whereas imports are based on LCs issued specially if the credit terms are higher say beyond 90 days.
- (v) Banks allowing transactions with reduced margins as compared to earlier transactions;
- (vi) Receipt against transactions from third parties.
- (vii) Deployment of advance received against the export leg in deposits and regular renewal of the same.
- (viii) Getting payments on adhoc basis and not for each transaction.

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- (ix) Concentration of merchanting trades with few parties.
- (x) Lower margins to the merchanting trader or losses incurred by them.

Bank's Control – Prevention or Detection

The banks need to ensure that all the conditions of the RBI Guidelines are complied with for each transaction. The banks need to maintain proper checklist confirming that all the items are as per RBI Guidelines for each transaction. The merchanting trades by nature are riskier ones as compared to other transactions and hence enhanced due diligence is required to be exercised in such cases.

The banks need to ensure that the documents are received and verified prior to executing the transactions and the direct confirmations from the bank handling documents have been taken.

Audit Process

The auditors need to ensure that the banks are ensuring the RBI Guidelines in toto and they have appropriate controls and documentation with regard to the transactions. The auditor should also devise its checklist for the cases selected for scrutiny. Apart from the specific guidelines mentioned, the following key components need to be looked into based on the risk indicators.

- (i) As per the RBI Circular, the transactions should not involve foreign exchange outlay for a period beyond four months. It needs to be verified if the merchanting purchases are done against letters of credit whereas the merchanting sales are not against LC. Further, the credit period given to debtors needs to be reviewed including the actual recovery dates from the debtors.
- (ii) As per the RBI Master Circular No.14/2014-15 dated 1.7.2014 on export of goods and services: "Taking into account the evolving international trade practices, it has been decided to permit third party payments for export / import transactions subject to conditions as under: A) Firm irrevocable order backed by a tripartite agreement should be in place. However, it may not be insisted upon in cases where documentary evidence for circumstances leading to third party payments / name of the third party being mentioned in the irrevocable order/ invoice has been produced subject to: AD bank should be satisfied with the bona-fides of the transaction and export documents, such as, invoice / FIRC and AD bank should consider the FATF statements while handling such transactions."

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The bank needs to ensure that payments received from third parties are allowed to be appropriated only in such cases where the AD bank is fully satisfied with the bona fides of the transaction and export documents. Accordingly, such instances should be treated as an exception and not as a rule.

- (iii) As per the Master Circular No.13/2014-15 dated 1.7.2014: "The entire Merchanting Trade Transactions should be completed within an overall period of nine months and there should not be any outlay of foreign exchange beyond four months." The delays in receipt of money and also non-receipt of money beyond the time period of 9 months, if any, needs to be verified.
- (iv) The advance received needs to be used by the Company to extinguish the liability for LC first instead of its being put into FDR.
- (v) In case of AD bank allowing short-term deployment of advance funds for the intervening period in an interest bearing account, AD bank should ensure that the same is earmarked for making payment for the respective import leg. The auditors need to verify that these are not used to set off against subsequent sales made, while LC is being opened for the import leg.
- (vi) As per RBI Master Circular on export of goods & services No.14/2014-15 dated 1.7.2014, write-off of export bills has been dealt with in Section C.20, which contains various provisions. In case, if the party has written off any export bills, the AD bank needs to ensure adherence to the provisions. The auditors should carry out their own review of the same as well including whether Chartered Accountant's certificate, indicating the export realization in the preceding calendar year and also the amount of write-off already availed of during the year, if any, the relevant EDF to be written off, Bill No., invoice value, commodity exported, country of export is obtained. The CA certificate may also indicate that the export benefits, if any, availed of by the exporter have been surrendered.
- (vii) The Federation of Oils, Seeds and Fats Association Ltd (FOSFA) is a professional international contract issuing and arbitral body concerned exclusively with the world trade in oil seeds, oils and fats with 1103 members in 89 countries. FOSFA has standard forms of contracts covering goods shipped either CIF, C&F or FOB for Soybeans, Sunflower Seeds, rapeseed and others, Vegetable and marine oils and fats, refined oils and fats, from all origins worldwide for different

Concealment or Falsification of Documents

methods of transportation and different terms of trade (source: FOSFA International website). FOSFA prescribes different forms of contracts for different products and for different edible items. In case the merchanting trade includes edible items which are under the purview of FOSFA, then the compliance as per FOSFA norms needs to be ensured.

- (viii) The following may be perused with regard to additional conditions:
- Whether Third party documents are accepted
 - Whether Bill of lading is showing larger quantity than invoices.
 - Shipping documents prior to the date of the LC.
 - Bill of lading showing third party as the notified party and freight prepaid and/or freight payable as per charter party.
 - Non-availability of packing list and insurance copies
 - Non-availability of Certificate of age of the vessel and Certificate of Origin of Goods signed or issued by any local chamber of commerce or the local government
 - No mention of HS code on the invoices, contracts, Bills of lading etc. Internationally, the goods are known by the HS code which is the harmonized system code. HS codes are used by Customs authorities, statistical agencies, and other government regulatory bodies, to monitor and control the import and export of commodities.

The basic LC principle as enunciated in UCP-600 requires “complying presentation of documents”. In the normal course of business, documents are normally rejected and the seller has to correct the deficiencies in the documents.

Signal No. 13. Concealment of certain vital documents like master agreement, insurance coverage

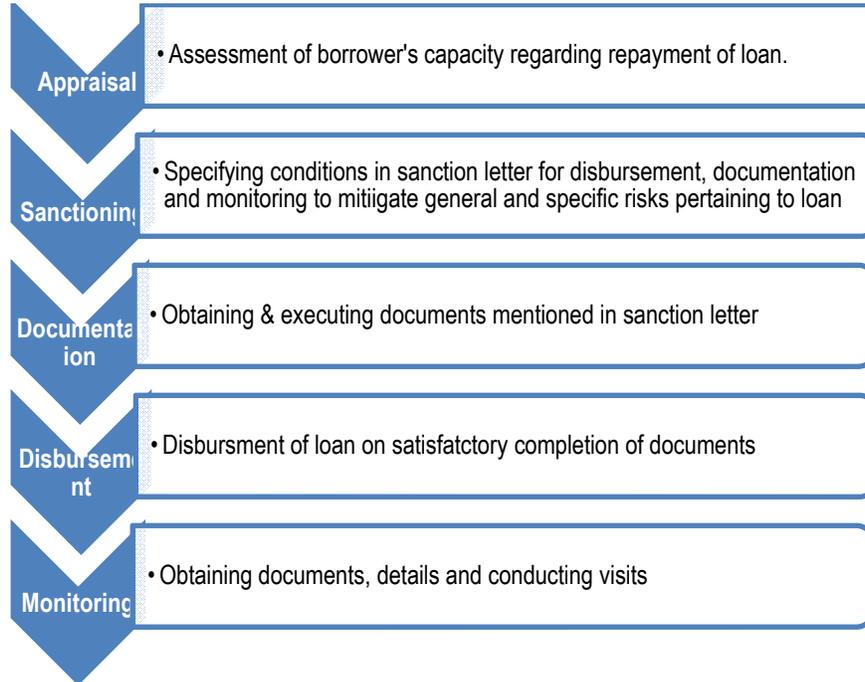
Introduction

The major income source of Banking industry is lending i.e., giving the loans to customer and charging interest on the same. Banking Industry carries an inherent risk related to lending of delinquencies in the loans. The delinquencies can arise due to loss to borrower in the business or liquidity shortage or over trading or wilful defaults. The banks carry out due diligence procedures before sanctioning, disbursement of loans and during the tenure

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of loan to avoid improper sanctioning or disbursement. To understand this let's understand the major activities in any loan account.

The major activities regarding loan account are as under:



The advance to any company means investment in that Company. Any financier wishes to understand the business of the investee company which requires that the Bank obtain all documents giving information about background of company as well as for specific transactions.

Banks generally obtain following documents apart from regular Know Your Customer documents

Financials Related documents / details – Audited financial statements, provisional financial statements, and projected financial statements, stock and book debt statements, QIS, FFR, etc.

Legal Documents - Title deeds & agreements, Loan agreements, Hypothecation/ Mortgage agreements, master franchise agreement, Insurance Policies with Bank Clause, etc.

Transaction related documents - Purchase order, Invoices for material purchases, Export bills, etc.

Concealment or Falsification of Documents

In addition to the above standard documents, banks should assess the documents required based on the purpose of loan and business of the borrower.

With globalization, Indian companies are entering into joint ventures or tie-ups with foreign companies. In most of these cases Indian company obtains franchisee or marketing or manufacturing rights or supply of material from the foreign or local companies. In such cases, it is important that the Bank obtains master franchise agreement to understand the terms and conditions like tenure of franchisee rights, termination clause, etc. Certain conditions like area of marketing, range of products, quality of products, etc. are considered while appraisal.

Non submission of documents as required by the Bank which helps banks in appraisal and monitoring are indication of unscrupulous intent of borrower.

The borrowers are required to share documents necessary for loan processing. However at times borrowers do not submit documents citing reasons like confidentiality, non-availability of concerned personnel, awaiting approval from partner, etc. If the Bank sanctions and disburses loan pending the receipt of agreement and the borrower keeps on deferring submission of these agreements, it creates suspicion.

Risk/Fraud Indicators/Source of Information

Illustrative list of indicators:

- (a) Non submission of master franchise agreement, sole selling agreements, purchase agreement, etc.
- (b) Delay / non submission of stock and book debt statements, QIS, FFR.
- (c) Avoidance of unit visits.
- (d) Delay in/ non submission of documents required for renewal.
- (e) Delay in submission of audited financial statements after submission of Income Tax return.
- (f) Non submission of insurance policy.
- (g) Submission of insurance policy without bank clause.
- (h) Non submission of bill of entry for imported machinery.
- (i) Non submission of installation certificate for machinery.
- (j) Non submission of permission from municipal authority for further construction after submission of initial permissions.

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- (k) Non-submission of share certificate and membership details in case of co-operative society.
- (l) Non-submission of NOC from industrial development corporation, society, builder, SEZ developers, etc.
- (m) Non- submission of certificates required from various government agencies
- (n) Non- submission of provisional financial statements
- (o) Non -submission original as well as renewed lease agreements
- (p) Non- submission of export documents in case of pre shipment finance
- (q) Non -submission of bill of entry for advance financed for imports
- (r) Non submission of account statements of other bank, if the running account current/cash credit account maintained with that bank
- (s) Non- submission of evidence of end use
- (t) Insurance of lesser value than maximum / average stock or value of plant, machinery, building, equipment's, etc.
- (u) Very old valuation report.
- (v) Non- availability of document vetting report from empanelled lawyer.
- (w) Non- availability of evidence for or Delay in Registration of Charges with Registrar of Companies.

Bank's Control- Prevention or Detection

- (i) Banks need to have a post disbursement monitoring cell separate from team/ branch regularly dealing with the borrower.
- (ii) Banks may develop an application to track and monitor pending documents from all borrowers and generating report on periodic intervals.
- (iii) Banks need to impart training to branch / operating staff on regular basis about appraisal and monitoring with emphasis on understanding about important documents
- (iv) Banks need to conduct and monitor post disbursement visits.
- (v) Banks may keep calendar of renewal dates of important licenses / agreement of borrowers to facilitate follow up for renewal.
- (vi) Banks should have penal procedures for non- submission of documents.

Concealment or Falsification of Documents

- (vii) Banks may have arrangement with insurance companies which shall send policies directly to the Bank.
- (viii) Banks may have process of follow up with borrower for audited financial statements after due date for filing income tax return is over.

Audit Process

The auditor should understand the process of appraisal, sanctioning, documentation and monitoring. The typical steps would be:

- Process walkthrough of each process.
- Understanding tracking process for non-available documents.
- Understanding tracking process for recurring documents like stock & book debt statements
- Understanding MIS / Returns submitted to controlling office which contains information about non- receipt of documents.
- Action taken by the Bank in case of non-receipt of document.

The auditor should review appraisal file to identify whether the Bank has requested for important documents required for assessment of borrower.

The observation of non-receipt should not be closed by charging penal interest. The same should appear in report / kept open till receipt of document.

Auditor should review concurrent and internal audit report to identify pending documents

Auditor should review self-audit report (if any) by official to identify pending documents.

Auditor should review document inward register / stock & book debt register/ insurance policy register or reports to understand trend in delay in submission of recurring documents.

Auditor should review legal audit report, if any.

Case Study

1. Non-availability procurement agreement: Agriculture Marketing Ltd. approached Bank to provide loan to farmers for crop loan against crop of baby corn. The company informed that it has entered into agreement with farmers for contract farming of baby corn and also requested expeditious processing of sanction and disbursement as the climate is favourable for baby corn.

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The Bank has sanctioned and disbursed loan to farmers after assessment based on land parcel and other factors of each farmer.

However the farmers could not repay the loan after harvesting the crop as they don't have marketing capability of baby corn and the personnel of the Company is not traceable. The farmers informed Bank that Company charged them 15% of loan amount for consultation regarding loan procedure.

In the above mentioned case, the Bank should have carried out due diligence of the company along with farmers. The procurement agreement between farmers and the company and the agreements between the Company and its customers should have been obtained.

2. Delay in submission of end use certificate: The Bank has sanctioned loan of Rs. 400 million to Medicines Limited for construction of pharmaceutical plant. Out of which the Bank has disbursed Rs. 300 million in tranches of Rs. 50 million, Rs.100 million and Rs. 150 million. The Company has submitted end use certificate on time after disbursement of first tranche, however delayed submission of end use certificate in second tranche. After disbursement of third tranche the Company has not submitted end use certificate after six months from disbursement and even after regular follow up by the Bank.

The Auditor suggested the Bank to conduct unit visit on immediate basis. During visit it was observed that the construction work of plant is suspended due to non-availability of requisite permissions and the funds of third tranche have been diverted.

Signal No. 14. Frequent Change in Accounting Period and/or Accounting Policies

Introduction

The Indian banking sector has experienced considerable growth and changes since liberalization of economy in 1991. Though the banking industry is generally well-regulated and supervised, the sector suffers from its own set of challenges when it comes to ethical practices, financial distress and corporate governance, banking frauds in India have often been treated as cost of doing business. Post liberalization the frequency, complexity and cost of banking frauds have increased manifold resulting in a very serious cause of concern for regulators, such as the Reserve Bank of India (RBI). RBI the regulator of banks in India defines fraud as "A deliberate act of omission or commission by any person, carried out in the course of a banking transaction or in the books of accounts maintained manually or

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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”.

Financial Statements give an overview on the financial health of the company based on which many investors, lenders, other stakeholders, government authority, etc. rely or place their reliance to make important decision on investments, lending, deposits, tax payments, etc. The view presented in the financial statements of a company of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The purpose is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different Companies.

There can be various reasons for change in Accounting period and /or Accounting policies such as to streamline the accounting period in line with parent company, to comply with local laws or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

However, frequent change in accounting period and/or accounting policies/estimates makes it difficult for the stakeholders to judge the decision of the management and frame their view and can raise eyebrows on the intention of the management.

Because accounting estimates are subjective, management may be able to influence accounting estimates to manipulate the financial statements. There are many items in financial statements for which companies use different policies. These are inventory valuation, investments and fixed assets, conversion of foreign currency and asset depreciation. Companies often manipulate these to inflate revenue, assets, cash inflow and understate expense, liabilities and cash outflow in financial statements.

Earnings and assets can be inflated by alternative accounting policies. If one sees frequent changes in these policies, there may be something fishy about the company's books.

The companies will be adapting financials statements to the new Accounting standards aligned with IFRS namely IndAS. Fair value concept will be adopted for many assets and liabilities as compared to current historical cost

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approach. There will be lot of subjectivity in measuring fair value of assets and liabilities.

On the first time adoption of IndAS, impact of GAAP adjustment due to convergence will be given in opening reserves as at start of comparative period.

Risk/Fraud Indicators/Source of Information

Illustrative list of indicators:

- Accounting methods that appear to favor form over substance
- Accounting principles/practices at variance with industry norms
- Accounting period at variance with industry norms
- Unusual accounting policies, particularly for revenue recognition and const deferrals – for example recognizing revenues before products have been shipped (“bill and hold”),
- Accounting policies are not clearly defined in financial statements. Generic policies given hence management can make changes in revenue recognition without highlighting any change in policy. Like percentage completion method for revenue from services.
- Deferring items that normally are expensed as incurred
- Create short period to avoid loss booking
- Financial results that seem “too good to be true” or significantly better than competitors’ - without substantive differences in operations.
- Frequent change in accounting judgments and account estimates without apparent reasons, increasing or decreasing reported earnings
- Comments by auditors in audit report or in Financial statements
- Variance in actual v/s Projections
- Turnover in operating account vis-à-vis revenue
- Failure by management to display or communicate proper reasoning for change in Accounting period/ estimates/policies
- Significant impact on Reserve on convergence with IndAS
- Fair value estimation in IndAS

Bank’s Control- Prevention or Detection

Banks need to have expert team to mitigate the risk which may arise because of change in accounting period and/or policies/estimates

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- Banks should have a strong internal rating agency, which evaluates big ticket projects before sanctioning loan.
- Bank should have sufficient staff with adequate industry specific knowledge who can based on holistic view of the industry question judgments/estimates of entity which are different from industry norms
- Banks' Credit Monitoring team should review the financial statement properly and vouch for the reasoning in case of variance in actual vis-à-vis projections, impact of change in accounting policies and estimates, etc.
- Banks should review auditors' comment and seek for justification or response of management on the same before appraisal process.
- Continuous monitoring the client's behavior of operation of account and news available in market.
- Banks should seek reasoning for certain rise in drawing power limit.
- Changes on adoption of IndAS need close monitoring.

Audit Process

The Auditor needs to get the comfort on Risk monitoring process, Credit Monitoring Process, Review and appraisal process of the Bank. Loan Sanctioning, Disbursements, Appraisal and Monitoring go hand in hand and the auditor needs to ensure compliance of internal process and guidelines by the respective process owners.

- Auditor should review the Internal audit report/ Concurrent audit report of the Bank Branch and should link the same with the Loan sanctioning and Disbursement process. Auditor should ensure that all the comments raised by internal/concurrent auditor on particular borrower are addressed while appraisal of loan and seek reasoning for non-compliance of the same.
- Auditor, being a financial engineer and expert, should also independently review the borrower's financials, Auditors report, ratios, etc. to identify and address any major concerns
- Comparing the unaudited and audited results of the company and seeking relevant reasoning
- Seeking reasoning for unusual change in accounting estimates/policies which are not in line with industry norms based on its professional knowledge

Early Signals of Fraud in Banking Sector

- Ensure that impact of change in policies is taken care while addressing the appraisal process
- Non-disclosure of relevant accounting policies or disclosures as required under the law

Case Study

Fraud on account of change in accounting Period

The Bank had asked XYZ Ltd. to submit financials for appraisal process. XYZ Ltd submitted financial statement for period ended January to December; however, the accounting period the company used to follow normally was April to March. When enquired with the management, they replied that the same was done to adopt unilateral accounting period in which is consistent with HO policy. The Bank accepted the same and made the appraisal.

Bank's auditor has compared the financials submitted vis-a-vis quarterly submission made for January to March of the following quarter and it was observed that there was huge loss booked in the company and if the company had provided April to March financials, there were all the chances that the appraisal would have got rejected and instead could have resulted in immediate call back of loan amount.

Fraud on account of change in accounting policies

Bank auditor upon comparing the policies of ABC Ltd. (the borrower of the Bank into retail business) observed that revenue recognition policy was not in sync with general industry norms. Upon further comparison, it was observed that the company frequently changes the revenue recognition policy which best suits the company's requirement and helps in recording high revenue. Management failed to justify the reasoning for the same and consequently account was downgraded and reported as fraud.

IndAS Convergence

On convergence to IndAS, High amount of provision for old receivables have been adjusted in opening reserve mentioning same as GAAP adjustments on account of change in provision of old GAAP vis a vis IndAS.

Signal No. 15. Claims not acknowledged as debt high

Introduction

Contingent liabilities are normally liabilities which may crystalize or may not crystallize in future. Normally these liabilities are not provided for and are disclosed by way of notes on accounts.

Concealment or Falsification of Documents

If such contingent liabilities are higher, it means risk to the company is very high and if they turn into actual liabilities, they could adversely affect the financial status of the company.

Risk/Fraud Indicators/Source of Information

This indicates open risk of the corporate which may turn into actual liabilities upon happening of certain events in future, for example, if a legal suit for some claim is filed against a company and if judgment comes against the company, company might have to pay such claims.

Bank's Control – Prevention or Detection

While reviewing accounts the bank officials should call for explanation for all contingent liabilities including claims against company not acknowledged as debt.

Audit Process

Auditor has to verify that bank has taken into consideration these contingent liabilities and the bank has obtained justification from the borrower for the same.

Case Study

The company A has following contingent liabilities:

The supplier of the company has filed a case against company for recovery of dues and the company is contending the same claiming that goods supplied were of inferior quality so the company has not honoured the payment of Rs.234.65 Lakhs.

Bank should examine the status and outcome of the case and see what type of accounting treatment will have be followed and how will that affect the financial status of the company.

Signal No. 16. Substantial increase in unbilled revenue year after year

Introduction

UNBILLED REVENUE is revenue which had been recognized but which had not been billed to the purchaser(s).

There can be various reasons for unbilled revenue recorded on the Balance Sheet (B/S). Government contractors with cost reimbursable contracts tend to have greater unbilled accounts. The most common reasons for unbilled A/R are the following:

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Timing differences: These can exist due to the normal timeframe of processing employee timesheets and invoices through the accounting system. These amounts should be billed as soon as possible in accordance with contractual terms.

Rate variances: These can exist when actual indirect rates are different than provisional or target rates. If actual rates are greater than provisional rates, an unbilled A/R balance will show on the company's B/S.

Costs in excess of billings: These can exist when the billings are less than the amount of revenue that can be recognized to date based on the percentage-of-completion method of revenue recognition.

However increase in such Unbilled revenue may raise a question, "Unbilled Revenue: Real or Imagined Assets"?

Borrowers can play with such elements to increase their revenue and show good turnover and increase the limit of borrowings against such receivables which are not going to realize anytime in near future. This kind of risk mainly arises in Real estate business, and IT sector where revenue is based on milestones or percentage completion method

Risk/Fraud Indicators/Source of Information

Illustrative list of indicators:

- Constant rise in unbilled revenues year after year with no new contract or arrangement
- Receivables grow substantially faster than sales perhaps aggressive revenue recognition- recording revenue too soon or granting extended credit terms
- Unbilled receivables grow faster than sales or billed receivables
- Inability to generate cash flows from operations while reporting earnings and earnings growth
- Substantial increase in related party transactions which are unaudited
- Frequent change in revenue recognition policy
- Non-movements in stock but increase in receivables
- Significant movements in inventory, disproportionately higher than the growth in turnover.
- Significant movements in receivables, disproportionately higher than the growth in turnover and/or increase in ageing of the receivables.

Concealment or Falsification of Documents

- Not routing of sales proceeds through bank
- Long old outstanding unbilled revenue

Bank's Control- Prevention or Detection

Internal Controls of the Banks should be robust enough to identify fraud which may arise because of ballooning of the receivables by fraud means

- Bank, if upon comparison, discovers that unbilled revenues are increasing year on year, it should ask for justification and contracts based on which revenue is recognized
- Bank may ask for contract details and periodic updating of same
- Bank should review the revenue recognition policy
- Bank should question on ageing of receivables vis-à-vis turnover in the operating account
- Bank should carry out receivables' audit periodically
- Bank can seek for direct balance confirmation
- Bank can seek external help by way of Forensic Experts for investigation Bank can seek conversion of unbilled revenue to billed revenue
- Aging of unbilled revenue
- Actual flow of funds in bank account

Audit Process

- Auditor should ensure that Bank has obtained all the list of contracts and basis of recording of revenue based on milestones especially cases where fixed price contract is there. Auditor should ensure that bank has followed appropriate procedures to ensure that there is no risk of unbilled revenue.
- Review of stock and debtors' statement vis-à-vis audited numbers
- Review of ageing of receivables
- Review of comments of auditors of Borrowers companies
- Seeking information of related party transactions
- Tracing of receivables in operating account vis-à-vis receivables
- Analyzing turnaround time for unbilled to billed revenue

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Case Study

- The risk taking is beginning to show on the balance sheet of the software companies in the form of 'unbilled revenue'. Simply put, this pertains to work completed for which a bill has not yet been issued to clients. Unbilled revenue has now grown from anywhere between 17% and 33% of total revenues for some leading IT firms. Need to review same vis- a- vis growth in actual revenue and funds received during the period.
- Change in method adopted for computation of percentage completion method which resulted in different trend in unbilled revenue.

Signal No. 17. Material Discrepancies in Annual Report

Introduction

An annual report is a comprehensive report on a company's activities throughout the preceding year. Annual reports are intended to give shareholders and other interested people information about the company's activities and financial performance. As per Companies Act, the companies are required to prepare and disclose annual reports, and file with the ROC Office.

An annual report can give a lot of important information about a company. An annual report typically contains an overview of performance, financial data, results of a company's operations, report on corporate governance, etc.

Since, the Annual Report is an important document of the Company, it is important that it is prepared in accordance with the requirements and contains all the relevant disclosures as required under the act for proper understanding of the concerned users.

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

It has been seen that many Annual Reports do not contain all the required information. There are certain discrepancies which are apparent from the reading of the same.

Risk/Fraud Indicators/Source of Information

The key risk / fraud indicators may be summarized as under:

- (i) Delayed submission of Annual Reports.
- (ii) Unsigned copies of Annual reports submitted to banks.

Concealment or Falsification of Documents

- (iii) Changes in dates of closure of Annual Accounts.
- (iv) Non-disclosure of required details in annual reports.
- (v) Using improper formats of financial statements;
- (vi) Material differences between stock statements, QIS etc. vis a vis Annual Reports.

Bank's Control – Prevention or Detection

The bank's need to ensure proper control in this regard. The following may be the key controls to be exercised by the banks:

- (i) To make list of all cases with due date of receipt of Annual Report and actual date of receipt of Annual Report
- (ii) To make list of all cases where the date of the annual Reports has been changed along with the copy of approval of ROC with regard to the same.
- (iii) Making comparison of the key data as per annual Report with that in stock statements, QIS and other data submitted by the borrower from time to time.
- (iv) Review of the Annual Reports by the concurrent auditors or inspection team of the bank relating to the particular branch.

Audit Process

The auditors need to ensure that the bank branches meticulously maintain all the required details in this regard. Based on the data analysis, the auditors need to select the cases where more detailed review of the Annual reports needs to be carried out to find out the material discrepancies in the same, if any. It may be noted that the auditors are not doing any audit of these Annual reports and shall only be reviewing the same from the perspective of apparent discrepancies from the Annual reports. Some of the key discrepancies to be identified from the annual reports are as under;

- (i) Differences in the key figures reported by the company in annual reports of the particular date with the figures reported by the company of that particular date to the banks earlier such as in stock statement, QIS, FFR, etc.
- (ii) Comparison of the Annual Reports with the figures submitted in CMA data and material differences in the same, if any.
- (iii) Non-disclosure of certain accounting policies which are required to be

Early Signals of Fraud in Banking Sector

- disclosed or disclosure of accounting policies in variance with the Accounting standards.
- (iv) Not making disclosures as required by various accounting standards.
 - (v) Improper format used by the company for its financial statements used by
 - (vi) Higher working capital used by the Company vis a vis the industry.
 - (vii) Non-provision towards debtors shown as outstanding for more than six months.
 - (viii) Significant related party transactions.
 - (ix) Default in repayment with other banks and institutions
 - (x) Additions to Fixed assets or uses of other long term assets from short term funds
 - (xi) Increase in loans to related parties, investments made or corporate guarantees issued without permission or concurrence of lenders
 - (xii) Not giving break- up of manufacturing sales and trading sales
 - (xiii) Adjustment of losses directly to reserves rather than routing the same from statement of profit and loss account
 - (xiv) Reflection of long terms assets as short term like Income Tax Advances, Loans given to related party, etc.
 - (xv) Non-amortization of intangible assets or amortization at higher period than desirable
 - (xvi) Non-provision towards impairment in value of fixed assets, investments, etc.
 - (xvii) Creation of deferred tax assets on carried forward income tax losses / depreciation without having virtual certainty for the same
 - (xviii) Carrying forward the sales promotion or other similar expenses in balance sheet rather than charging the same to statement of profit and loss
 - (xix) Carrying out transactions which are other in normal course of business

Signal No. 18. Significant inconsistencies within the annual report (between various sections)

Introduction

An annual report is a comprehensive report on a company's activities throughout the preceding year. Annual reports are intended to give shareholders and other interested people information about the company's activities and financial performance. As per Companies Act, the companies are required to prepare and disclose annual reports, and file with the ROC Office.

An annual report can give a lot of important information about a company. An annual report typically contains an overview of performance, financial data, results of a company's operations, report on corporate governance, etc.

Since, the Annual Report is an important document of the Company, it is important that it is prepared in accordance with the requirements and contains all the relevant disclosures as required under the act for proper understanding of the concerned users.

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

It has been seen that in certain cases, the annual Reports contain information which are inconsistent and an apparent reading reveals such inconsistencies.

Risk/Fraud Indicators/Source of Information

The key risk / fraud indicators may be summarized as under:

- (i) Non-disclosure of required details in annual reports.
- (ii) Using improper formats of financial statements;
- (iii) Qualifications made by auditors / comments by auditor in CARO.
- (iv) Not having independent directors though required as per law
- (v) The accounts being approved late / submitted late to lenders
- (vi) Significant related party transactions.

Bank's Control – Prevention or Detection

The banks need to ensure proper control in this regard. The following may be the key controls to be exercised by the banks:

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- (i) To make list of all cases with due date of receipt of Annual Report and actual date of receipt of Annual Report
- (ii) Making comparison of the key data as per annual Report vis- a- vis as per stock statements, QIS and other data submitted by the borrower from time to time.
- (iii) Review of the Annual Reports by the concurrent auditors or inspection team of the bank relating to the particular branch
- (iv) Going through the qualifications made by the statutory auditors in main report and / or in CARO

Audit Process

The auditors need to ensure that the bank branches meticulously maintain all the required details in this regard. Based on the data analysis, the auditors need to select the cases where more detailed review of the Annual reports needs to be carried out to find out the significant inconsistencies in the same, if any. It may be noted that the auditors are not doing any audit of these Annual reports and shall only be reviewing the same from the perspective of apparent inconsistencies from the Annual reports. Some of the significant inconsistencies to be identified from the annual reports are as under;

- (i) Differences in the key figures reported by the company in annual reports of the particular date with the figures reported by the company of that particular date to the banks earlier like in stock statement, QIS, FFR, etc.
- (ii) Whether the security as per the bank sanction letter with regard to loans sanctioned and the disclosures made in the Annual report is matching.
- (iii) Whether the defaults made by the company are appropriately disclosed in the financial statements as well as in the CARO report issued by the auditor of the company.
- (iv) Not making disclosures as required by various accounting standards.
- (v) Improper format of the financial statements used by the company.
- (vi) The breakup of debtors reported by the company to banks vis- a- vis as disclosed in the Annual Report. Non-provision towards debtors shown as outstanding for more than six months.
- (vii) Reflection of Income tax refund and certain other apparent items which should be of long term nature but are shown as short term advance.

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- (viii) In case of disbursement of funds by lenders, whether the annual report reflects usage of fund for the purpose for which it was meant. Compare the same with the certificate of utilization provided by the company.
- (ix) Matching of data as given in the director's report with that in the Annual report.
- (x) Creation of deferred tax assets on carried forward income tax losses / depreciation without having virtual certainty for the same
- (xi) Carrying forward the sales promotion or other similar expenses in balance sheet rather than charging the same to statement of profit and loss
- (xii) Reflection of turnover with marginal profits / losses
- (xiii) High proportion of stock / debtors as compared to the industry

Signal No. 19. Poor disclosure of materially adverse information and no qualification by the Statutory Auditors

Introduction

Accounting Standards issued by ICAI and notified under Companies Act 2013 specify the disclosures to be made along with financial statements by the non-corporate entities and Companies respectively. Also, Companies Act 2013, specifies disclosure requirements.

These standards required certain additional information to be provided with statement of profit & loss account/ statement of profit & loss and Balance Sheet. This information helps reader to understand the methodology of preparation of financial statements as well as also contains explanatory notes about the accounting heads in the financial statements.

THE COMPANIES (INDIAN ACCOUNTING STANDARDS) RULES, 2015 specifies the new accounting standards which are compliant with International Financial Reporting Standards. These standards also specify disclosures related to the same.

The Banks use these disclosures while carrying out analysis of the Balance Sheet at the time of appraisal. These disclosures are not only a part of compliance but also an important element in understanding financial statement of the borrower. Method of Disclosures also reflects the corporate governance in an organization.

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If the financial statements do not contain disclosures as required by ICAI or Companies Act 2013 or any other statutes which require additional disclosure then the auditor needs to give remarks about the same in the audit report.

In the absence of disclosures, the financial statements are incomplete for a reader.

If the financial statements do not contain any of the required disclosures and the auditor makes an observation about the same in his audit report, then the bank should immediately seek an explanation from the borrower about it. If the explanation is not satisfactory, the account should be marked for close monitoring.

If the financial statements do not disclose any of the required disclosure and the auditor does not comment on the same in his audit report, the bank should put such account under close monitoring and simultaneously seek explanation from the borrower.

Risk/Fraud Indicators/Source Of Information

- (a) Non-disclosure of related party transactions.
- (b) Inconsistent method of accounting of income & expenditure.
- (c) Director's report vis – a – vis Disclosure in Financial Statements.
- (d) Related party disclosures vis-à-vis transactions in account.
- (e) Average salary as per employee benefits vis-à-vis salary expenditure in profit & loss account.
- (f) Ambiguous accounting policies.
- (g) Clause related to default in repayment of loans to Bank in CARO vis-à-vis overdue status as per review of bank account.
- (h) Non-disclosure of discontinuation of operations.
- (i) Issuance of equity shares as per balance sheet, however non-disclosure in reconciliation of shares.
- (j) Method of stock valuation vis-à-vis details in stock audit report.
- (k) Interest for project under implementation but no information about capitalization of the same, if any.
- (l) Large amount loan to subsidiaries, that was was not disclosed in notes to accounts.

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- (m) Incorrect classification of nature of activity in cash flow.
- (n) Less disclosure as compared to peers.
- (o) Non-disclosure of details of security for borrowings.

Bank's Control- Prevention Or Detection

- (a) Bank needs to impart training to branch / operating staff on regular basis about requirements of disclosure as per AS issued by ICAI and Companies Act 2013 and relating same to the operations in bank account.
- (b) Receipt of audited financial statements within specific period from finalization of Financial Statements.
- (c) Bank needs to have team for analysis of financial statements vis – a – vis operations in Bank accounts.
- (d) Bank may have process of obtaining financial statements / confirmation for financial statements directly from the Auditor of the Borrower.
- (e) Gathering information of auditors through internet, ICAI website and other sources.

Audit Process

- (a) The auditor should understand the process of receipt and analysis of audited financial statements.
- (b) The auditor should review appraisal note, memorandum for loan to committees, etc. to understand nature and background of Borrower and disclosure requirements.
- (c) The auditor might study disclosure of peers or companies from same industry and compare with the disclosure of borrower.
- (d) The auditor should compare areas of business of borrower and segment reporting.
- (e) The auditor should carry out cash flow analysis vis-à-vis financial statements.

Case Study

- (a) Review of bank statement revealed that Evergreen Ltd., a borrower of the bank has transferred funds of Rs. 500 millions to a Director of the

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Company, but the same has not been disclosed in Financial Statements and not reported by the Auditor of the borrower in Audit Report.

- (b) 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.
- (c) In the appraisal note prepared for sanctioning of new term loan for installation of new plant with advance machinery at the new segment at Nasik and closing down old plant which is manufacturing segment which shall be discontinued over the span of a year at Baroda. However the closure of plant has not been disclosed as discontinued operation in Audited Financial Statements and Auditor has not qualified the same in his Auditors' Report.

Section 3

Diversion of Funds

Signal No. 20. Frequent change in the scope of the project to be undertaken by the borrower

Introduction

The Reserve Bank of India ('RBI') vide its circular dated 7 May 2015 'Framework for dealing with frauds' had introduced concept of Red Flagged Account wherein certain Early Warning Signals ('EWS') were prescribed to alert Banks about weakness or potential wrong-doing in the loan accounts which may turn out to be fraudulent.

The former RBI Governor, Mr. Raghuram Rajan, in his speech at CII's first banking summit on 11 February 2016 had explained the rationale of the Asset Quality Review ('AQR') conducted by RBI. Excerpts from his speech "Over time, as you know, a number of large projects in the economy have run into difficulty. Reasons, as Mr. Mundra articulated this morning, include poor project evaluation, extensive project delays, poor monitoring and cost overruns, and the effects of global overcapacity on prices and imports. Loans to these projects have become stressed". This indicated that during RBI AQR, they have observed instances where there has been change in the scope of the projects due to reasons mentioned above and should be considered as one of the key factors for potential RFA.

Under the extant RBI Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, any change in the repayment schedule of a project loan caused due to an increase in the project outlay on account of increase in scope and size of the project would not be treated as restructuring subject to fulfilling mentioned criteria. In order to prevent misuse of this exemption, RBI through its 'Framework for dealing with frauds' identified 'frequent change in the scope of the project' as one of the EWS which should be monitored by the Banks through its credit monitoring process.

Risk of frequent change in scope of the project to be undertaken by the borrower:

- Borrowers resorting to frequent change in scope only to keep seeking unjustifiable extension of time for completion of the project.

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- Final project takes a shape that is very different from what was envisaged at initial appraisal stage, and as a result many of the associated aspects e.g. Management competency for executing the revised project of a different scale and complexity, may not have been suitably assessed.
- Inefficiencies due to changes to the project resulting in unjustifiable Project delays and the resultant increase / cost overruns of Project expenditure.

Fraud Indicators in frequent change of scope of the project to be undertaken by the borrower:

- Changes to project scope are not due to significant changes/ developments post initial appraisal of the project but changes that could have been reasonably anticipated at project appraisal stage.
- Lack of significant progress/ delays in project with no apparent road blocks.
- Project milestones not being met for no genuine reasons.
- Transfer of funds to related parties as loans / investments not related to the project.
- Increased non-budgeted expenditure.
- Long-running disputes with Vendors / service providers.
- Questionable quality of professional expert involved in TEV study and many caveats in TEV Study Report.
- Change in plan of the project close to the documented Date of Commencement of Commercial Operation.
- Dealing with suppliers with susceptible market reputation.
- Purchase orders for significant machinery from small time distributors instead of Original Equipment Manufacturers (OEM's).

Source of Information:

- Audited end-use certificates
- Periodical project status certificate from approved engineer
- Periodical site visits by Bank personnel
- TEV Study Report
- Joint Lenders / Consortium Meeting Minutes

Bank's Control:

In order to avoid diversion of funds for loans for a Project under Implementation, there is need for banks to adopt robust controls in this area. An Indicative list of controls has been give below for change in scope for project to be undertaken by borrower:

1. Bank's need to ensure independence of Risk Team for the Projects
2. Internalizing Bank's learning from past experience of such cases with itself and in the industry
3. Robustness of bank's challenge and review of applications/ requests towards scope changes
4. Controls over engaging independent, competent and reputed agencies for conducting TEV studies
5. Bank's control on breach of covenants and enforcing consequence.
6. Sharing of Information with fellow lenders and collectively taking punitive action for such cases on timely basis
7. Bank's vigil mechanism to scrutinize granularly the end use for purposes mentioned and ensure timely certification of end use
8. Robustness of Bank's process of monitoring the progress of the project including the budgeted expenditure vis-à-vis actual expenditure
9. Controls around funds transferred through the account under their observation in case of bilateral lending or under the specified account under Consortium lending
10. Bank should ensure that there is no change in equity proportion post funding for change in scope
11. Bank personnel should regularly visit the project site to monitor the project status. Bank should also appoint engineer to give progress report on a periodical basis
12. Bank should ensure that all RBI guidelines in relation to change in scope have been complied before approving this

Audit Process:

As an auditor, it will be important to monitor these kinds of project loans where there is change in scope frequently. Below is a list of audit procedures which should be followed:

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1. Evaluate robustness of bank's internal controls to detect scope of changes that are indicative of fraud
2. Auditors need to challenge the entire process with enquiry, inspection, sighting and verifying relevant documents. Matters of importance should be highlighted to those charged with governance and reported as part of Long Form Audit Report or Internal control findings for financial reporting as the case may be.
3. Auditors need to verify the bank's assessment regarding the viability of the project at the time of change in scope
4. Auditor should read in detail TEV report carried out at the time of change in scope
5. Auditor should verify the bank's assessment whether all regulatory clearances have been or is most likely to be obtained before approving the change in scope of the project. Identify whether the project is facing any delays on account of land acquisition, environment clearances and contractual issues and/or any cost overruns have been incurred etc.
6. Auditor should verify the actual performance and lenders engineer report to assess the project progress
7. Auditor should verify banks assessment of RBI compliance with respect to Change in scope of the project

Case Study

ABC Ltd. has undertaken a project for Hydro Plant which was envisaged to be completed in 4 years. After a year, ABC Limited decided to change the project outlay due to environmental factors which increased the scope of the project. The Bank verified the compliance with RBI guidelines and decided to appoint a Fresh DCCO date. 6 months before the DCCO, ABC Ltd again approached the Bank for fresh funding as they wanted to add another plant to the existing project. Although, the project outlay had increased by more than 25% as required by RBI Guidelines, the bank on their appraisal found out that most of the released funds had been utilized to retire the debt in other companies and the borrower did not utilize the debt in construction of the project. In this scenario, it is important that Banks do an appropriate appraisal post any disbursement and prior to sanctioning any additional funding to any Borrower.

Signal No. 21. Sales proceeds are not routed through consortium / member bank/ lender bank

Symptoms of sickness in a borrower account can be detected when the sale proceeds are not routed through the consortium / member bank / lender bank; i.e. credit summations in the account are not commensurate with the total sales. However, this sickness in the account is also an early warning sign on fraud wherein the borrower purposely does not route the sale proceeds through his main banking account.

Companies have been found to be taking part in 'high sea sales' with investment from Indian banks but the funds are either used for other purposes or are not repaid after the sale has been made, and instead, routed to other channels, resulting in a NPA. Such breach of contract is another instance of fraud since the funds are not utilized for the purpose for which they were initially set out and based on the project evaluated by the banker.

In a few cases, the borrowers might be having current accounts with other banks which aren't disclosed to the lender bank under which the borrower enjoys the benefits of CC accounts. Under this case, the borrowers tend to service only the interest on regular basis to avoid being declared NPA as per the IRAC norms of RBI. However, the turnover isn't reflected in the CC accounts. With parallel sales taking place and funds routed through other accounts, the lender banks tend to lose out on the primary security in the form of stocks and debtors which are usually a self-declaration of the borrower on the basis of which, the Drawing power is ascertained. The periodicity of stock audits of the borrowers is usually on annual basis thereby allowing the borrowers the required time and effort to manipulate the figures of stock and debtors.

In many cases, borrowers inflate the stocks and continue to provide incorrect ageing of the stocks and debtors thereby duping the bank about the actual picture of the nature of business. When the credit turnover in the CC account is not in line with the sales of the borrower, the Drawing Power of the borrower ideally should decrease because of stocks getting depleted as a result of sale, thereby protecting the interest of the lending banks to some extent. However, the over-reliance of the banks on the self-declaration of the borrowers in the stock statement may affect this scenario. Banks do not obtain periodical statements party wise, age wise, and of outstanding debts and continue to allow drawing power.

Usually, the sales not routed through the lending bank account is not

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detected until the Annual Audited financials of the borrower is provided to the lender bank or during stock audit, whichever is earlier. However, many borrowers withdraw the funds from other accounts before the end of the year for multiple business transactions thereby showing depleted figures in the cash & cash equivalents section of the Balance sheet. To cope with this problem, the bank needs to be vigilant about the other bank accounts maintained by the borrower and needs to obtain bank statements on regular basis for studying the same and identifying any anomalies.

Banks obtain undertakings from borrowers that they will not operate accounts elsewhere without their permission. Parallel Banks opening Current accounts have to obtain undertakings that they do not have borrowings elsewhere. However, both these stipulations are bypassed.

Banks do give permissions to borrowers to open Current accounts on a case to case basis – say, a borrower needing a bank operational account near his factory where the lending branch may not have a branch nearby. Also, various locations nationally or internationally may necessitate opening and operating of accounts for which the lending branch may grant permission.

However, lending banks monitor the operations by periodically obtaining bank statements of these accounts to ensure that the credits in the account match with the turnover disclosed by the borrower. Ideally, as a thumb rule, banks monitor whether the Credits in Bank accounts net of inter se transfers or Cheque bouncing and Capital Inflows are 5 times the sanctioned Limits or match the Projected annual Turnover based on which the working capital Limits are sanctioned to the Borrower.

Thus, non- routing of Sales Proceeds through the lending / consortium or Member bank needs to be reviewed in depth as an early warning signal for –

1. Sales have actually gone down or are not happening either due to strikes / stoppages / temporary shutdowns or closure of business activity or a plant or a product –
2. Opening of current accounts in other banks without knowledge of the lending bank primarily to divert funds so that end use monitoring is averted
3. Liquidity crunch may necessitate not depositing funds in the operating bank account to avoid appropriation to repayment of liabilities
4. Business being done in cash not being recorded in Books to avoid taxation & other issues

Alternatively the funds could be deposited in Bank accounts for genuine operational conveniences like in a Bank account close to the factory premise for payment of salaries / wages or in banks which have bigger geographical pan India reach to take advantage of faster collections & credits in accounts.

Conclusion

Bank needs to review the reasons for all these actions as this will ultimately affect the ability to recover their dues through borrower cash flows.

Further, if the intent of the borrower is to indulge in unhealthy business practices, the same intent could be easily stretched to non-repayment of borrowed amounts and tampering with the securities pledged / hypothecated to the bank to avoid repayment. Banks need to take prompt action to ensure that the account does not turn into an NPA.

In short, the credit risk of the bank increases significantly after the above two warning signals emerge and banks should take proactive steps to identify these early warning signals, and having identified the same take immediate steps to preserve their security and ensure repayment of dues to minimize their credit risk.

Signal No. 22. High value RTGS payment to unrelated parties

Introduction

The Reserve Bank of India ('RBI') vide its circular dated 7 May 2015 'Framework for dealing with frauds' had introduced concept of Red- Flagged Accounts wherein certain Early Warning Signals ('EWS') were prescribed to alert banks about weakness or potential wrong doing in the loan accounts which may turn out to be fraudulent.

The Deputy RBI Governor, Mr. S.S. Mundra, in his speech at CII's first banking summit on 11 February 2016 had given insights of the Asset Quality Review ('AQR') conducted by RBI; few of them are as follows:

- Funding satellite entities
- Round tripping
- Short term overdraft to repay then overdraft paid by fresh sanctions
- Sale of assets within groups inflated

The above indicated instances where funds were transferred within related entities to postpone identification of non-performing accounts and should be considered as one of the key factors for potential RFA.

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Further, the former RBI Governor, Mr. Raghuram Rajan, in his speech at Assocham on 22 June 2016 on the subject "Resolving stress in the Banking system" highlighted instances about fraud by diversion of funds. Excerpts from his speech "I am not saying that there was no malfeasance – the country's investigative agencies are looking into some cases such as those where undue influence was used in getting loans, or where actual fraud has been committed by diverting funds out of a company, either through over-invoicing imports sourced via a promoter-owned subsidiary abroad or exporting to related shell companies abroad and then claiming they defaulted." Also, the RBI has set up a fraud monitoring cell to coordinate the early reporting of fraud cases to the investigative agencies and for those who have diverted money out of their companies, especially, into highly visible assets abroad, a stern message sent by bankers sitting together with investigative agencies should help send the message that the alternatives to repayment can be harsh.

Risk/Fraud Indicators/Source of Information

Risk in high value RTGS payment to unrelated parties:

- Bypass banks controls for transfer of funds and result in Illegitimate use of funds/ non-genuine transactions/ Round tripping
- Fraud Indicators in high value RTGS payment to unrelated parties
- No genuine business transactions with the unrelated party
- Advance payment without any agreement with the unrelated party or with fictitious party
- Payments to wilful defaulter parties
- Large amount of commission paid for services provided by middlemen
- Purchase of supplies / capital goods from intermediates instead of OEMs without valid reason or at an unexplainable significant variation
- Issue of end use certificates by CAs who are not Auditors of the borrower or highly caveated certificates or scope limitations imposed
- Significant delay in obtaining end use certificate
- Receipt of funds from promoter post heavy disbursement by the borrower
- Receipt of similar amount near the funds transfer date
- Quid pro quo arrangements

Diversion of Funds

Source of Information in high value RTGS payment to unrelated parties:

- Account Statement and bank's scrutiny mechanism to identify significant high value transaction
- End-use certificate
- Suspicious Transaction report
- Project information on key suppliers and significant arrangements gathered by banks in the normal course of monitoring

Bank's Control – Detection

1. Suspicious transaction report (STR) generated should be reviewed by the Business Team on a live basis
2. While performing Asset Quality Review, transactions should be reviewed by the bank's risk team
3. Threshold limit should be fixed for triggering early warning signals in terms of number of transactions in an account/location from where the account is operated/value of transaction in the account
4. Insist on end use certificates from auditors and careful scrutiny of such end use certificates and corroboration with the account statements and investigation of deviations/ diversions observed

Audit Process

1. Evaluate robustness of bank's controls
2. Reporting divergences to audit committees, in LFAR
3. Auditor should verify the bank's process in identifying high value RTGS payment to unrelated parties
4. Auditor should select transactions from STR reports and identify high value transactions
5. Auditor should identify stressed borrowers and identify their transaction patterns.

Auditor should verify end use certificates to confirm that the borrower is in compliance with sanction terms.

Case Study

ABC Ltd., a borrower, has undertaken project loan for building power plant. As and when there was disbursement in the account, ABC Ltd. used to make payment to the suppliers as per the confirmation received by the bank.

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However, when this account was scrutinized, 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. This raised a question on utilization of the funds and eventually the bank concluded that there was diversion of funds.

Signal No. 23. Increase in borrowings, despite huge cash and cash equivalents in Borrower's balance sheet

Increase in borrowings of the bank's client despite having huge cash and cash equivalent can be viewed as an early warning signal of fraud. The most important question arising here is regarding the need for borrowed funds. Banks must try and understand the motive behind the borrower's willingness to raise debt when he has adequate balance with him to meet his need for working capital requirements and other capital asset funding. One of the obvious questions arising here would be the cost benefit analysis of the debt funds to the borrower. The borrower must understand that borrowings come at a specific cost whereas idle funds in the form of cash and cash equivalents do not earn much for the borrower. Hence, borrowings ideally could be avoided unless there is a specific plan to deploy the idle cash and cash equivalents to some other project or purpose whereas the current borrowings should also be appropriately justified as to the end use of such borrowed funds to generate sufficient cash flows to pay back the interest costs along with the principal repayment due.

This can be further explained through an illustration as below –

Mr. X's business firm has cash & cash equivalent worth Rs. 100 Lakhs which are held in the forms of Bank Balance & Fixed Deposits. Mr. X approaches 'Y' Bank for a Business Development Loan of Rs. 50 Lakhs when the lending rate of the bank is @ 12% p.a.

Here, the borrower is willing to accept interest commitment to the extent of Rs. 6 lakhs in spite of having the required funds which, at the most, would generate returns at 8% p.a. under the current investment structure of the entity. Here, Mr. X has the opportunity of saving the interest cost utilizing the amount so required from the entity's existing funds, thereby saving net cost of 4% p.a. Here, the bank "Y" needs to understand the view point of Mr. X for obtaining the mentioned loan and ensure there is no ulterior motive of defaulting on repayment of loan.

Banks should study all the relevant financial ratios especially the Interest Service Coverage and The Debt Service Coverage ratios to establish

Diversion of Funds

relationship between the liabilities & assets of the borrower. Current ratio is one such ratio which depicts the ability of the entity to service its short liabilities against its short- term assets. An entity with healthy current ratio of greater than 1.5:1 would usually not need any borrowings for Working Capital funding except in extraordinary circumstances. This needs to be understood in detail by the bank and accordingly the credibility of the borrower should be established with the understanding that the borrowing is not done with any malicious intent.

Banks should also look into the possibility that huge cash balances in the borrower's Balance Sheet could only be at the close of the day and the same would be needed and utilized for day-to-day operations the next day which replenishes again only at the close of the day. In this case, the business model of the borrower is such that the funds are needed intra-day for which they might need to borrow for that tenure only. Banks need to actually understand the business dynamics for fund requirement. Possibility of the business lacking the financial discipline or a systematic approach in maintaining a robust accounting system may be there but banks need to deep dive before sanctioning any funding limits to ensure that there is a genuine requirement and there is no concealment or falsification of transactions to justify borrowings.

Thus Cash and Bank Balances on hand in the Books of Accounts of a Borrowers and his request asking for raising borrowing limits needs to be viewed in depth as it could be an early warning signal for –

1. Inability of the borrower to effectively plan his borrowing and cash flow requirements
2. Fictitious Cash & Bank balances
3. Fictitious borrowings
4. Borrowing for a term with a high premature repayment clause despite having funds, and the high penalty serving as a disincentive to repay
5. Some other hidden covenants which affect ability to repay the debt
6. Borrowings being in nature of equity rather than debt not converted for some reason
7. Borrowings from related parties
8. Borrowings not used for the basic business objects – Fund diversion
9. Borrowing needed for short term purposes
10. Cash & bank Balances may be arising as of date due to an

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extraordinary sale event of an asset / part of business and may be on hand only for a short term and may be utilized shortly while the borrowing may be needed for a long term

11. Borrower has many lines of business or business at various locations and a particular business or location may need funding whereas other locations / lines of business would be flush with funds
12. Borrower may opt for a sanction as a fund back-up plan but not utilize the same and may be willing to pay the commitment charges
13. Borrower may have a future expansion plan needing term loans of longer tenure

To conclude - Banks should go in with necessary and relevant data to ensure that borrowings are need-based and will be utilized for business purposes and will be repaid out of business cash flows and that current Cash Balances on hand do not suggest otherwise any ulterior motive.

Section 4

Issues in Primary/ Collateral Security

Signal No. 24. Dispute on Title of Collateral Security

Introduction

The bank extends finances for various borrowers against primary security in the form of tangible (movable and immovable) as well as intangible (book debts, tenancy rights, etc.). However, as a matter of abundant precaution or as a conservative principal or as per internal policy of the bank, the bank may insist on obtaining collateral security from the borrower over and above the primary security. The said collateral security may or may not be owned by the borrower but may be owned by a third party (for which the lender would obtain a NoC / guarantee).

Risk/Fraud Indicators/Source of Information

There are various indicators which an auditor can analyse, a few of which are enumerated below:

- (i) The title of the property may not be in the name of the borrower and adequate documentation is not taken on record w.r.t. the consent of the borrower
- (ii) The title of the property might be in the name of joint holders (borrower being one of them) or HUF or AoP or Bol and the consent of co-owners might not have been obtained
- (iii) The collateral security offered as security is owned by a private limited company and the same is offered for loan granted to director of the said private limited company
- (iv) The search and title clearance report of the property is not obtained or some defect are specified in the Report
- (v) Absence of availability of latest valuation Report of the (movable or immovable) property

There are various sources of information to gather and analyse the above-mentioned indicators:

- (i) In case of immovable property
 - (a) Inspection Report

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- (b) Search and Title Clearance Report from Advocate on the bank's panel
 - (c) Valuation Certificate from Government Approved Valuator on the bank's panel
 - (d) In case if the borrower (and owner of the immovable property) is a company, documents confirming charge creation
- (ii) In case of movable property
- (a) Inspection Report
 - (b) Valuation Certificate from Government Approved Valuator on the bank's panel, who is technically competent for doing valuation
 - (c) Invoice and receipts of the purchase of the movable property
 - (d) In case the borrower (and owner of the immovable property) is a company, documents confirming charge creation
- (iii) Insurance cover for collateral security with bank clause

Bank's Control – Prevention or Detection

The bank needs to have an internal policy as regards the guidelines issued as regards the collateral security w.r.t. following aspects:

- (i) Guidelines as regards circumstances wherein collateral security is to be obtained
- (ii) Type of security acceptable as collateral security
- (iii) Guidelines as regards documentation w.r.t. collateral security owned by third party
- (iv) Prerequisite of obtaining title clearance and valuation report of collateral security

Audit Process

An auditor can review the process of obtaining a collateral security to determine whether the same is in sync with the bank's internal guidelines and with reference to the Title Clearance and Valuation Reports besides Inspection Reports. If required, the auditor may opt for inspection of the collateral security and / or obtain fresh valuation and / or title clearance certificate if desired.

Case Study

ABC Ltd. had applied for a Term Loan of Rs. 4 crores for procurement of machinery of Rs. 6 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 and the same is not detrimental to the benefit of the co-parceners of the HUF.

Mr. X had applied for a Term Loan of Rs. 50 lakhs for interior decoration work at his residence and had offered a collateral security owned by private limited 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.

Mr. X had applied for a Term Loan of Rs. 50 lakhs for interior decoration work at his residence and had offered a collateral security owned by himself and his brother. The bank has not obtained NoC from the co-owner of the property.

As the bank has obtained collateral security which is owned by the borrower jointly with his brother, the NoC of the co-owner needs to be obtained by the bank.

Signal No. 25. Request received from the borrower to postpone the inspection of the godown for flimsy reasons.

Introduction

It is important for banks to periodically review the securities obtained under the credit facilities. The periodic inspection gives an idea about operations, inventory positions. However, in some cases there are various requests to delay / cancel the physical visit by bank officials or auditors on flimsy reasons. Such approach may be to prevent / delay / cancel the visit by Branch Officials / Stock Auditors.

Risk/Fraud Indicators/Source of Information

There are various indicators / flimsy reasons generally cited by borrowers to prevent the visit. For instance,

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1. No electricity
2. Concerned staff on holiday
3. Staff busy with other work
4. Water seepage in factory
5. Ongoing Renovation work at godown

Bank's Control – Prevention or Detection

In case of repeated deferral requests for site visits / stock audit, the bank should independently review the veracity of reasons / situations as indicated by the borrower.

Audit Process

1. Review the cases wherein the site visits / stock audits have not been carried out at prescribed interval. Communication with borrower should also be reviewed.
2. Ascertain whether the filings with different tax departments depict any impact of the situation (say no electricity, water ingress) which prevents carrying out of godown / premises visit.

Signal No. 26. Exclusive collateral charged to a number of lenders without NOC of existing charge holders

Introduction

Collateral security is a security cover taken by the bank in addition to the prime security. Prime security is the security against which the advances take place. To give an example, if working capital loans are given, components of working capital such as Inventory, Debtors etc. form the prime security. If a loan is given against the machinery, the concerned machinery is the prime security. In short, the assets required for the conduct of the business against which loans are obtained form the prime security.

Collateral security as against the same is security other than the prime security. Collateral security is generally (and preferably) free from any encumbrances. The banks have charge on this security. In case the borrower defaults and the prime security fails to recover the dues sufficiently, banks have right to liquidate the collateral security to recover the residual dues.

Hence collateral security is mere backup that may be invoked in case the prime securities do not fetch the outstanding in the books of the bank. The collateral required depends on the loan type and amount. The amount of the loan offered depends on the value of the security.

Issues in Primary/Collateral Security

Here are types of collaterals:

- Real estate: Properties like real estate usually guarantee loans as they can be worth a lot. They may be houses, shopping centres, office complexes and warehouses, just to name a few.
- Natural resources: Natural resources such as oil, gas or coal can be used as collateral when applying for a loan. They are most often used prior to starting up a big project as well as for long-term loans.
- Equipment and machinery: Factory equipment or other machineries are worth a large sum of money which is why they're commonly used as collateral. They're appropriate if the borrower is a syndicate or a large company.
- Stocks and bonds: Treasury certificates, certificates of deposits as well as stock and bonds which can be converted to cash readily can be used as collaterals too. The loan amount will depend on the value of these marketable securities with some amount being set aside to compensate for fluctuations in the market.

It is expected that the lender verifies the title before creating a charge. This helps lender keep the claim over the asset in case of default.

Generally, the banks take the exclusive charge over the security to avoid any additional legal risk. However in case of consortium or multiple banking, banks do share the charge. The sharing takes place in the following ways:

- Pari-passu charge: In this type of charge, all the lenders are given equitable right in the ratio of their respective outstanding
- 2nd Charge: In this case, one of the lenders takes exclusive right of recovery. The other lender has a right over the residual value of the asset after the outstanding of the 1st charge holder is satisfied.
- Equal Charge: In this case the value of the collateral is divided equally among lenders.

Risk/Fraud Indicators/Source of Information

Risks relating to collateral security include:

- Credit risk: How much unsecured credit exposure is acceptable in case of a customer?
- Collateral risk: What is the likelihood that the collateral will decrease in value or will not be easily marketable?

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- Legal risk: Is there a risk of delay on a sale of the collateral or a risk of challenge on the rights to collateral?
- Fraud risk: Is there a possibility of the borrower giving the same collateral security to multiple lenders without informing or taking NOC from the lender from whom the loans are obtained against the said security?

We shall evaluate the last stated risk in this chapter.

Fraud Indicators

- A frequent request for ad hoc / temporary funds is the first indicator where there is probability of the borrower turning to alternative modes of finance
- Dealing with any other finance Organisation (banks or other than banks) to meet fund requirements
- Purchase of co-operative bank or society shares. This may be a meagre amount but this is not possible unless some borrowing activity has taken place
- If the collateral security is created by simple deposit of title deeds (equitable mortgage) without involving a third party, such mortgage is highly susceptible to fraud. Especially, if the borrower is a realty developer, probability of more than one "original" sale deed being submitted to more than one lender cannot be ruled out
- Weak borrower account transactions suddenly getting financially active without any change in the business situation
- Delay in completing the mortgage registration procedure by the borrower
- Any payment of mortgage registration through the account without lender being aware of such transaction
- Resignation by the directors where director's personal guarantees are mandated in the sanction letter

Source of Information

- The financial statements of the borrower
- Mortgage registration department where the mortgages are registered

Bank's Control- Prevention or Detection

- Periodic verification and valuation of the collateral asset that include search at the registration office

Issues in Primary/Collateral Security

- Regular stock audits in case the borrower is above threshold for such monitoring
- Study of audit reports, if the borrower is a company. Companies act mandates auditor to comment on ownership relating issues in respect of fixed assets of the company
- To act upon and verify any of the indications given above
- Regularization of ad hoc loans exclusively taken on the basis of value of collateral

Audit Process

- To observe whether any of the indicators above prevail
- To study behavioral pattern of the financial transactions through bank statement
- Obtain and study the search reports
- Ensure that the management has conducted necessary monitoring steps as per the policy, and observation, if any, on such visits/ inspections/ audits are acted upon.

Case Study

- The borrower was enjoying large credit limit of ₹ 40 Cr. The enhancement was sought to ₹ 60 cr. However the balance sheet showed steady increase in the shares of a co-operative society without corresponding loan or any facility in the books. The share amount was very meager starting at ₹ 500 in the first year to ₹ 2500 in the third year. A stock audit was mandated before giving the raise. The stock audit revealed certain papers that suggested that the collateral was indeed given to a local co-operative society for other business that was not banked through this bank.
- The borrower is enjoying ₹ 100 cr. facility. The company was in the business of textile where it would supply to many traders and wholesalers. The outstanding was always almost fully utilized. The borrower showed the turnover of ₹ 400 cr. However, the bank statement evidenced only little less than ₹ 200 cr. The activity was seen sluggish in the first half of the financial year. However, sudden financial activity started with unusually large amounts of ₹ 20 cr. and above. These definitely could not have been business transactions. The inspection was carried out. The collateral security that belonged to

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one of the shareholders - (son of a Director) who was not a director- had been mortgaged to another institution to take more monies.

Signal No. 27. Critical issues highlighted in the stock audit report

Introduction

Stock Audit is an important activity to ascertain physical availability of stock (primary security) as disclosed by borrower on periodic basis. It also gives insight in business operations of the borrower. Moreover, with a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of Rs. 5 crore and above, stock audit at annual intervals by external agencies appointed as per the guidelines approved by the bank's board is mandatory in order to enhance the reliability of stock valuation.

Risk/Fraud Indicators/Source of Information

The purpose of submission of monthly stock statement to the bank is to ascertain drawing power / limit for the borrower. However, in order to avail higher limit (than the prescribed level) the borrowers tend to inflate the figures of Stock and Debtors. Analytical review along with observations of Stock Auditor will give an idea about irregularities being carried out by the borrower. The discrepancy in Stock Audit may not lead to a fraud by the borrower in all cases. However, material discrepancies observed in Stock Audit should be seen from the perspective of fraud by borrower.

Bank's Control – Prevention or Detection

Bank should review the Stock Audit report and seek responses from borrower for all the observations given in Audit Report.

Analytical process of addition to Debtors vis- a- vis turnover should be carried out. In the same way, addition to Inventory vis- a- vis Purchases should also be carried out. Any disproportionate change should be closely monitored.

Audit Process

An auditor should closely review the Stock Audit Report. The auditor should also carry out analytical process to determine inflated Debtors or Inventory.

Auditor should review the Inventory valuation method applied by the borrower and whether the same complies with the method prescribed by the Accounting Standards issued by ICAI.

Issues in Primary/Collateral Security

Auditor may review whether any non-moving stock, machinery spares have been included in inventory to inflate the stock valuation. For instance, in case of borrowers in FMCG, Pharmaceutical sector, whether expired stock has been included in inventory.

Auditor may review the cases wherein the receivable amount is already received through Bill discounting / factoring, but the receivable is still shown as Trade Receivable under book debts statement.

Case Study

Following are a few important observations generally noted during stock audit. Along with other corroborative evidence, such observations should be reviewed from the perspective of any fraudulent activity by borrower.

1. Inclusion of expired stock in the amount of stock thereby inflating the value of inventory.
2. Inventory not valued as per the guidelines of Accounting Standard notified by ICAI. Moreover, inclusion of Excise Duty and VAT in the valuation of Raw Material for which credit is available.
3. Significant difference in amount of receivables as per monthly stock statement and as per verification by Stock Auditor.
4. Incremental change in receivables within a period is significantly higher than the incremental change in amount of sales for the respective period.
5. LC Creditors and Outstanding on account of Trade Credit (Buyer's Credit) have not been disclosed separately at the time of submission of stock Statement to the Bank thereby inflating the value of primary security for higher Drawing Power.
6. Maintenance of two separate ledgers for a party from whom both sales and purchase transactions have been carried out. In case of ledger opened under debtor, the same is included in Stock Statement whereas in case of ledger opened under creditor, the same is not shown in Stock Statement.
7. 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 with Audited Balance Sheet for the year ended 31st March

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8. Material difference in Quantity of Stock as per stock register and as per physical verification.
9. Part of fixed asset is considered under stock of spares / consumables / raw materials at the time of submission of Stock Statement.

Signal No. 28. Liabilities appearing in ROC search report, not reported by the borrower in its annual report

Introduction

There is no such requirement that the ROC charge for collateral security be reported under annual report. The financial statement report charge over main security only. I therefore suggest deleting this chapter.

Signal No. 29 Non-production of original bills for verification upon request

Introduction

The bank extends finance for various purposes wherein the end use of the funding needs to be verified and evidenced on the basis of available documentary evidences, original bills being an important documentary evidence. As a matter of routine process, the bank generally insists upon submission of the documents evidencing the end use of the advance extended and the borrower submits the original invoices to the bank as proof of end use along with receipts of the payments made against such invoices.

Risk/Fraud Indicators/Source of Information

There are various indicators which an auditor can analyse, a few of which are enumerated below:

- (i) Proforma invoices submitted at the time of application for loan but the original invoices are not submitted subsequently
- (ii) Details of machinery (asset) specified in proforma invoices differing from those mentioned in the invoices submitted subsequently
- (iii) Estimates (Kachcha bill) submitted instead of original bill
- (iv) Xerox copies of invoice submitted instead of original invoice
- (v) Bill submitted not having details of Excise / VAT / CST Nos

There are various sources of information to gather and analyse the above-mentioned indicators:

Issues in Primary/Collateral Security

- (i) Verification of the vendor (supplier) from whom the machinery /vehicle/ material is proposed to be procured
- (ii) In case of vehicle loans, the credential of the vendor can be established on verification of authorized dealership of the vendor
- (iii) In case of supplier being an excise dealer, the verification of excise invoice can be insisted upon

Bank's Control – Prevention or Detection

The bank can have a system of obtaining proforma invoice at the time of submission of proposal by the borrower and ensuring that original invoice is being made available by the borrower on release of the advance.

Audit Process

An auditor can review the process of verification of original invoices by the bank, and if required, may insist on verification of original invoices. There are a couple of examples related to production of original invoices which are cited below for reference purpose under Case Study.

Case Study

ABC Ltd. had applied for a Term Loan of Rs. 5 crores for procurement of machinery of Rs. 7.50 crores from supplier – XYZ Enterprises. ABC Ltd. had deposited own contribution of Rs. 2.50 crores with the bank and the bank had made a remittance of Rs. 7.50 crores to XYZ Enterprises by RTGS against the proforma invoice as submitted by the borrower. However, 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.

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

The bank had sanctioned working capital finance to ABC Ltd. against primary security of stock and book debts. The bank had appointed stock auditors for verification of drawing power. The stock auditor while verifying the purchases w.r.t. stock, observes that though the purchases were made from excise registered dealer, the borrower was not having excise invoices on records though commercial invoices were on record.

It would be pertinent to note that the verification of the end use of the advance can be effectively verified on the basis of the original bill.

Signal No. 30. Significant movements in inventory, disproportionately differing from change in the turnover

Introduction

In case of working capital facility sanctioned against primary security of book debts and stock, the borrower is required to submit the stock statements to the bank on a periodic basis (generally monthly unless otherwise specified). A thorough analysis of stock statements submitted by borrower can throw light on the anomalies, if any, in the said stock statements. The bank needs to ensure that the stock statement provided by the borrower contains adequate details in the stock statement so as to enable the user of the stock statement to use the data in an effective manner (e.g.: the stock statement needs to contain the details of movement of stock, book debts and trade creditors and not mere closing balances as at month-end).

Risk/Fraud Indicators/Source of Information

There are various indicators which an auditor can analyse, a few of which are enumerated below:

- (i) Inward movement in stock not being in sync with movement in trade creditors
- (ii) Outward movement in stock not being in sync with movement in trade creditors
- (iii) Movement of Work in Progress not in sync with consumption of raw material and / or addition of Finished Goods
- (iv) Disproportionate Work-In-Progress vis-à-vis the production cycle
- (v) Disproportionate stock vis-à-vis turnover of the borrower

There are various sources of information to gather and analyse the above-mentioned indicators:

- (i) The data provided by the borrower in the stock statements
- (ii) VAT Returns of the borrower
- (iii) Excise Returns and records of the borrower
- (iv) VAT Audit and Tax Audit Reports of the borrower

Bank's Control – Prevention or Detection

The bank can have the data assimilated from the stock statement analysis, based on various parameters, which are predefined in the system; data consistency of the stock details can be reviewed at regular intervals.

Audit Process

An auditor can review the process of receipt of the stock statement and analysis of the same as made by the bank officials on various parameters. A couple of examples of the same are given below under Case Study.

Case Study

ABC Ltd. was a manufacturer of speciality chemicals with typical production cycle of 3 to 4 days. The said company had availed working capital finance from XYZ Bank against primary security of Stock and book debts. The borrower was regular in submission of stock statements and was having an annual turnover of Rs. 50 crores and gross profit margin of 25%. However, the stock statements were having amount of WIP in the range of 2 to 2.50 crores.

If the typical production cycle of the borrower is between 3 to 4 days and considering the gross profit margin being at 25%, the typical WIP should have been in the range of 0.30 to 0.40 crores. Thus, the clarification as regards substantial higher value of 2 to 2.50 needs to be sought as the said value of WIP indicates the stock in process for around 19 days as compared to typical production cycle of 3 to 4 days.

ABC Ltd. was a trading concern and had availed working capital finance from XYZ Bank against primary security of stock and book debts. The company is in the practice of purchasing and selling goods on credit basis only. The stock statements have details of movement of stock and book debts and trade creditors, the details of which are as follows:

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

Presuming that if the gross profit margin is at 10%, the above statement reflects an anomaly w.r.t. the figure of addition to book debts, which should have been at 44 (deduction of stock plus 10% margin) instead of 54. Further, it can be noted that though the stock has increased by 30, the increase in trade creditors is deviating at 10.

The reviewer of the Stock Statement should conduct analysis of the correlation between decrease in stock with increase in book debts and increase in stock with increase in trade creditors.

Signal No. 31. Significant movements in receivables, disproportionately differing from change in the turnover and/or increase in ageing of the receivables

Introduction

For working capital facility sanctioned against primary security of book debts, the borrower is required to submit periodic statement on book debts. As per the terms and conditions of sanction letter, the applicable margin is applied on the book debts to arrive at drawing power. Analytical review of changes in age wise receivables vis-a-vis turnover reveals the discrepancies in disclosure by the borrower.

Risk/Fraud Indicators/Source of Information

There are various indicators which an auditor can analyse. A few of these are enumerated below:

- (i) Increase in debtors is higher than increase in turnover when compared on a time scale.
- (ii) Computation of Book Debts ageing based on Due Date of Invoice and not the Invoice Date.
- (iii) Inclusion of Advances (other than on account of sales) as debtors.

There are various sources of information to gather and analyse the above-mentioned indicators:

- (i) The data provided by the borrower in the book debt statements
- (ii) VAT & Excise Returns of the borrower to ascertain the turnover for the period
- (iii) Comparison of two book debt statements to incremental change

Bank's Control – Prevention or Detection

The bank should compile data on turnover and should record incremental change in the book debts between two immediate book debt statements. Analytical process should be carried out on the said amount.

Manner of computation of ageing of Book Debts should be verified.

Audit Process

Review the process of receipt of book debts. Moreover, carry out analytical analysis of incremental change in turnover and book debts.

Auditor may review the various book debt statements submitted to identify stagnant debtors to review the ageing of book debts.

Case Study

(a) Receivables within cover period (as per sanctioned letter) were higher than the amount of sales for the respective period.

For instance, Sales as per Stock Statement for last 3 months is Rs. 100. However, receivables for less than 90 days as per stock statement are Rs. 150.

Signal No. 32. Increase in Fixed Assets, without corresponding increase in long term sources (when project is implemented)

Introduction

The Asset Liability Management principle is that long- term assets should be financed out of long-term sources. For, when short-term fund obligations are due, the long-term assets will not mature simultaneously, and as such there will be shortage of working capital funds. Hence there will be financial pressure on an organization. Financing long term asset out of short term loan is not a prudent financial decision. Many organizations fail due to such situations.

Many a time, when we compare financial data of current year with previous year, we find that fixed assets have increased; however, when we see corresponding sources of funding for the same, we find that long- term sources have not increased. The short- term funds have been used for long term purposes.

Risk/Fraud Indicators/Source of Information

Sources of information for verification in this area would be financial 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.

Bank's Control – Prevention or Detection

When such projects are under implementation for each asset being acquired / built, the bank should seek information about how the same is being funded and keep check on it to ensure that the same is being funded through long-term sources of funds. No working capital should be used for assets being created.

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Audit Process

Auditor will have to see the bank has complied with the process of verification of funding of fixed assets being done through long- term sources. Financial statements of current period and previous period can be compared and seen that for increase in fixed asset there is corresponding increase in long- term resources, be it capital or long- term loans.

Signal No. 33. Costing of the project which is greatly at variance with standard cost of installation of the project

Introduction

The project cost is worked out based on various factors and many a time there is cost escalation in the project and result is there is wide variance with standard cost of the project. This is possible due to error in calculation / error in estimate of cost and also due to increase in prices of material to be used in project. Further, cost overrun can also be due to non-implementation of project in time i.e. time overrun.

Further, there is also 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. With inflated figures, he may get loans and manage to put his contributions. In such cases also, project becomes non-viable if unnecessary project cost is inflated and project break- evens are higher.

Risk/Fraud Indicators/Source of Information

Such projects sometimes become non-viable. Loans and advances given by banks are at risk and banks are not able to recover their funds as projects are not able to start operations / take up.

Bank's Control – Prevention or Detection

Standard cost data which is submitted needs to be evaluated by experts and possibilities of cost overrun and time overrun should be examined.

Audit Process

Auditor will have to see the bank has properly checked data submitted by borrower for the standard cost of project and is properly taking care of cost / time overrun situations. Proper technical evaluations have been done at all stages and during project implementation also project is closely monitored.

Section 5

Inter-Group/Concentration of Transactions

Signal No. 34. Funds coming from other banks to liquidate the outstanding loan amount except in normal course

Introduction

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

Generally, the funds are received from other banks to liquidate the outstanding loan amount in normal course under the following circumstances:

1. Exposure limit of existing bank attained
2. Terms & Conditions of existing bank are not acceptable to the borrower who is moving to other banks.
3. Merger & Acquisition of borrower results in change in bankers.
4. Take out finance.
5. Capital introduction to liquidate the entire loan amount.
6. Account is generally categorized as Standard Asset.

In addition to the above, if the funds have been received from the other bank accounts in following circumstances detailed scrutiny is required.

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

Risk/Fraud Indicators/Source of Information

Following are the risks related to funds coming from other banks to liquidate the outstanding loan amount unless in normal course:

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- Money Laundering – Funds received by discounting cheque / bills near about the reporting date, which will be returned unpaid after the reporting date. Source of funds not known to the bank.
- Irregular account – There is a possibility that the borrower was unable to repay the loan or service interest, resulting in the account slipping to NPA. Funds are received from unknown source/ not a genuine source.

Bank's Control – Prevention or Detection

Bank receives application from the borrower regarding liquidation of loan account through the funds either by raising loan from other sources or raising capital from other sources.

Bank gives outstanding position as on a particular date for liquidation of loan account.

Banks generally don't ask for sources of funds in case of direct credit received in loan accounts.

Audit Process

Following are the check points for verification of adhoc sanction

- Verify the source of credit in the borrower account for liquidation of loan
- Check whether the Cheque / Bills discounted are lodged with the respective drawers.
- Check whether the Cheque / Bills discounted are not returned unpaid within reasonable time.
- Check whether the details are submitted by the borrower for liquidation of loan account.
- In case of receipt of funds through NEFT/RTGS, verify whether the bank has verified the source of funds.

Signal No. 35. Floating front/associate companies by investing borrowed money

Introduction

Many borrowers have multiple businesses and more than one industry in which they operate. Financial health of all the companies may not be equal. If some company is in need of money or is not doing well and requires funds and is not able to raise the funds due to one or other reason/s, it is seen that there is diversion of funds from one company to another company and

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because of the other companies' poor financial health, even the company doing good business suffers and turn into a weak company. Over-trading by promoters is also part of this type of cases.

Risk/Fraud Indicators/Source of Information

Sources of information for verification in this area would be financial statements for the past two years. If an organization has transferred the funds by way of loans or advances to a sister concern or made investments in sister concerns, the activity needs to be put under scanner to find out genuineness of the same.

Bank's Control – Prevention or Detection

The bank, by regularly monitoring the financial information and asking the borrowers for justification of related party transactions, can control these types of damages to the company running well. Further, the bank should draft appropriate terms and conditions for prior permission for such investments / loans and advances.

Audit Process

Auditor will have to review the financial statements and terms and conditions of loan sanctioned. If there are such transactions, auditor should report the same and seek explanation from the bank whether the bank has obtained justification from the borrower for transactions with related parties. Cases of unjustified transactions should be reported urgently.

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.

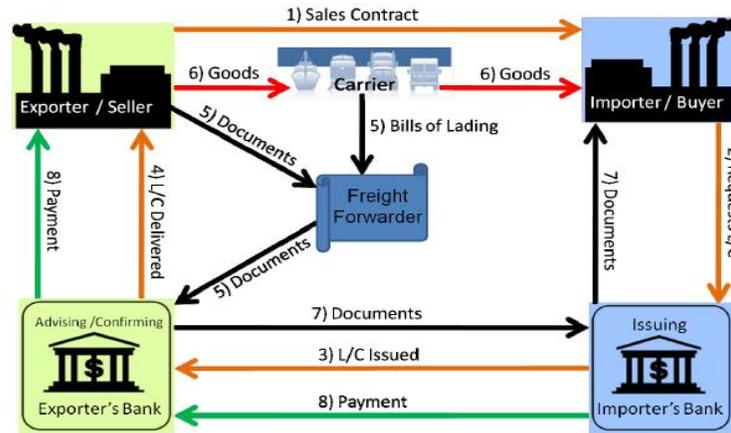
Signal No. 36. LCs issued for local trade / related party transactions without underlying trade transaction

Introduction

A letter of credit is a document that a financial institution or similar party issues to a seller of goods or services which provides that the issuer will pay the seller for goods or services. The issuer then seeks reimbursement from the buyer or from the buyer's bank. The document serves essentially as a guarantee to the seller that it will be paid by the issuer of the letter of credit regardless of whether the buyer ultimately pays or fails to pay. In this way, the risk that the buyer will fail to pay is transferred from the seller to the letter

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of credit's issuer. The same can be explained as under:



As explained above, the letter of credit shall be always supported by underlying trade transactions. The letter of credit (LC) is part of non-fund based facilities extended to the customer. As per RBI master circular on Guarantees and Co-acceptances, following precautions should be taken in the case of Letter of Credit:

1. Banks should not extend any non-fund based facilities or additional/ad-hoc credit facilities to parties who are not their regular constituents, nor should they discount bills drawn under LCs, or otherwise, for beneficiaries who are not their regular clients. `
2. In the case of LCs for import of goods, banks should be very vigilant while making payment to the overseas suppliers on the basis of shipping documents.

Also, safeguards suggested for issuance of LCs as per extant guidelines for Urban Co-operative Banks while issuing LCs include:

- (a) LCs are not issued for amounts out of proportion to the borrowers' genuine requirements and these are opened only after ensuring that the borrowers have made adequate arrangements for retiring the bills received under LCs out of their own resources or from the existing borrowing arrangements;
- (b) Where LCs are for purchase of raw materials, borrowers do not maintain unduly high inventory of raw materials in relation to the norms / past trends. Where such LCs are to be opened on D/A basis, credit on the relative purchase is duly taken into account for the purpose of working out drawing power in cash credit accounts;

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- (c) In the case of borrowers having banking arrangements on a consortium basis, the LCs are opened within the sanctioned limit on the basis of the agreed share of each of the banks. Member-banks should not, however, open LCs outside the sanctioned limits without the knowledge of the lead bank / other banks;
- (d) If there is no formal consortium arrangement for financing the borrower, LCs should not be opened by the existing bank or a new bank, without the knowledge of the other banks;
- (e) LCs for acquisition of capital goods should be opened only after banks have satisfied themselves about tying up of funds for meeting the relative liability by way of providing for long term funds or term loans from financial institutions / banks;
- (f) In no case, should working capital limits be allowed to be utilized for retiring bills pertaining to acquisition of capital assets.

The Banks generally obtain the following documents before issuing the LCs:

1. Application form for opening LC
2. Copy of proforma Invoice
3. Purchase order duly attested by the buyer
4. Copy of insurance, if applicable and
5. Approval of Branch Head / Competent Authority for issuance of LC

In case of local trades, the LCs can be misused to raise finance through unauthentic trade transaction, that is, the bills drawn under LC are discounted, though the sale transaction is not genuine. The same is also known as accommodation.

The risk of fraud in case of local trades is relatively higher as compared to international trade because the local trades are less regulated as compared to international trade.

The bills discounted by the bank drawn under LCs carry lesser credit risk as they have exposure to the Bank and not on the buyer, hence the Banks issuing LCs should be diligent about creditworthiness and genuineness of underlying trade transactions.

The trade transactions between related parties are always looked fon with suspicion in terms of arm's length basis and accommodation entries.

Currently, LCs are issued through SFMS platform, hence frauds through

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presentation of forged LCs have been reduced. However the risk of fraud pertaining to unauthentic trade transactions is still very high.

Risk/Fraud Indicators/Source of Information

Illustrative list of indicators:

- (i) The LCs issued in favor of seller, whose name is not appearing in the list of suppliers.
- (ii) The buyer and seller have warehouses/ factories in the same area.
- (iii) The transportation expenses in Statement of Profit & Loss are lower as compared to trade transactions.
- (iv) The beneficiary of LCs is a related party.
- (v) The LCs are issued though the customer and seller have been dealing for many years.
- (vi) The transportation of goods is done through local transporters and not through IBA approved transporter.
- (vii) In case of beneficiary's bank, the funds disbursed by discounting bills are transferred immediately to another bank.
- (viii) In case of beneficiary's bank, the operations in current account/ cash credit account are not commensurate with amount of bills discounted.
- (ix) The consideration amount in transactions is exorbitantly high as compared to peers.
- (x) The frequency of issuance of LCs and working capital cycle assessed at the time of appraisal does not match.
- (xi) The quantity of orders placed and LCs issued thereof do not match with production capacity of the customer.
- (xii) In case of beneficiary's bank, the operations in current account/ cash credit account are not commensurate with amount of bills discounted.
- (xiii) Discounting of LCs without detailed sanction procedure.
- (xiv) Limit of LCs against immoveable properties without detailed working capital assessment.

Bank's Control- Prevention or Detection

- (i) The Bank needs to carry out due diligence for assessing authenticity of the transaction based on nature of business of the seller and customer, history of the customer, size of business of the customer,

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relationship between seller and customer, the locations of the warehouse/ factory of customer and seller.

- (ii) The Bank issues LCs based on sanctioned limits which have approval from competent authority.
- (iii) The Bank may carry out limited due diligence of the seller/beneficiary through desktop search or local sources.
- (iv) The Bank discounts bills under LCs based on sanctioned limits and not adhoc basis.
- (v) The regular current/cash credit account of the Customer is maintained with the Bank.
- (vi) The end use of funds disbursed through bills discounting under LCs are monitored closely.
- (vii) The list of related parties should be obtained from customer or disclosures in financial statements and the same need to be tracked with LCs issued.

Audit Process

The auditor should understand the process of issuance of LC and bill discounting. The typical steps would be:

- Walkthrough of each internal 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.
- Understanding processes followed for bill discounting and confirmation of LCs.
- Access and other IT Controls assessment in respect of Structured Financial Messaging System (SFMS) application.

The auditor should review the appraisal and sanction files to understand the sanctioned limits for LCs and/or bill discounting.

The auditor should obtain list of related parties from the Bank or annual report of the customer and identify LCs issued in favour of the same.

The auditor should verify addresses of beneficiaries in whose favour majority LCs were issued. If the same are in the vicinity of the customer's address

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then further documents like mode of transport, evidence of transport should be called for.

The auditor may verify names of LC beneficiaries appears in the list of suppliers and similarly names of LC issuing parties in the list of customers of borrower.

The auditor may verify whether the quantity in transactions is commensurate with size of business of customer.

Case Study

(a) Forged LCs: XYZ had availed loan by furnishing the fake letter of credit to the ABC bank which was purportedly issued by DEF Bank. On failure to honour commitment by XYZ, the ABC bank contacted DEF bank for honouring the LCs, which was denied by the DEF bank stating that the LCs were not issued by the same.

(b) LCs & related parties: Good Enterprises limited, a trader in metal, has bill discounting facility against LCs with ABC bank. Good Enterprise Limited sells goods to Happy Limited against LCs and discounts the same from ABC bank. The documents submitted by Good Enterprises Ltd. contain Tax Invoice, Lorry receipt, LC issued on SFMS platform, etc. On verification of the lorry receipt, it was observed that the transporter is local one and warehouse of Good Enterprises Ltd. is just two plots away from warehouse of Happy Limited. Further verification revealed that directors of both Companies are related parties. Detailed investigation revealed that lorry receipt was fake and goods were never physically transported, the funds disbursed against the bill were used for short term working capital requirement of a Partnership Firm where directors of both Companies are partners.

Signal No. 37. Large number of transactions with inter-connected companies and large outstanding from such companies

Interconnected Companies / Related Companies

Interconnected or related companies are companies that do not have an arm's-length relationship (e.g., a relationship involving independent, competing interests). This could be due to both companies being part of the same business group or could stem from family or personal ties between officials of two companies.

Eg. A company that controls or is controlled by another company, often one that is in the same business group.

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Intra-Group Transactions

These are financial or commercial transactions which involve two companies of the same group simultaneously.

The most common example is the issuing of a sales invoice for the supply of services. The company issuing the invoice will recognize a receivable in its balance sheet and revenue from the sale on the income statement whereas the purchasing company will have a payable on its balance sheet and an expense on the income statement.

In fact, on the closing date, the consolidated balance sheet will include an asset and a liability resulting from a “reciprocal” transaction which doesn’t exist within the group. At the same time, the revenue and expenses in the income statement will be overvalued, as they include all of the internal transactions for the period.

Sec 188 of the Companies Act gives directions on Related Party Transactions.

These contracts have to be at an arm’s length basis i.e. without any conflict of interest.

These transactions have to be approved by the Board of Directors at a duly convened meeting.

In addition to Directors’ approval, a prior approval of members by means of a special resolution is also needed if,

1. The paid- up share capital of the company exceeds Rs. 10 Crores.
2. Sale, purchase or supply of any goods or materials directly or through appointment of agents exceeds 25% of the annual turnover.
3. Selling or otherwise disposing of, or buying, property of any kind directly or through appointment of agents exceeding 10% of net worth

Verification of transactions between interconnected companies

- The key is to ensure that these transactions have been conducted at fair market prices as if the parties were unrelated.
- Care should be taken to ensure that these transactions are not done for profit booking adjustments with intent to avoid taxes or to increase turnover so as to get benefits of higher working capital limits –
- One should see in depth whether there has been an actual underlying transfer of goods & services from one company to another

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accompanied by actual transfer of funds and these are not merely book entries to inflate profits / assets.

- One needs to ascertain whether these transactions are in the normal course of business for purchase of goods or rendering of services which are done by one entity & needed by the other entity. The prices at which the transactions are conducted should be at rates for both the entities with other parties for similar dealings in terms of quality and quantity.
- The quantum of such transactions as a percentage to transactions with other parties also needs to be seen. If transactions with interconnected companies are substantial, then apart from a Concentration Risk, there exists a doubt as to the necessity and the genuineness of the transaction. Hence, enquiries need to be done to satisfy oneself of the economic rationale underlying such transactions.
- The trend in the quantum of such transactions over the previous few years could be seen to know whether the percentage is increasing or decreasing or steady.
- Per se such transactions raise a Red Flag & need additional checks to satisfy oneself on the genuineness or economic rationale.
- Transactions other than by way of Sales – Purchases or rendering of services i.e. by way of fund transfers, say, lending / borrowing need to be seen from Funds Diversion perspective also. Underlying rates of interest at which such transactions are conducted should be looked into.
- The Company borrowing may not need funds but because of its strong financials or track record of repayment or managerial or business strength may be in a position to raise funds and that too at better rates of interest and a sister concern may not have that advantage. Hence funds could be borrowed by one entity and lent to another. In this case, either the transaction should be revenue neutral or at a mark-up. In either case, one needs to look whether there is no unfair advantage or disadvantage to any company. The transactions should be fair and done at rates at which it would have been done had there been no relation or connection between the two companies.

Points to be noted

- While dealing with companies which have large transactions with interconnected companies, the bank should evaluate the entire group

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as a whole while trying to establish the credibility of the company with whom they might do business. The bank needs to obtain financial statements of all these interconnected companies to view the macro picture or the position after eliminating all inter-group transactions to arrive at overall working capital requirements for ensuring there is no double financing.

- In case of loans and advances, bankers may demand guarantees of inter-connected companies having a reasonably good corporate image, strong balance sheet and good loan repayment track record. This will ensure that though the borrowing company might not be in a position to repay the loan, the other Group Company will honour and repay the dues.
- In case of Working Capital loans, Cash credits etc., bankers will evaluate the stock and debtors of the entire group company against the finance charges and principal repayment of the group. Weightage on evaluation of the group ensures that not just the borrowing company but also the interconnected companies with whom the large number of transactions are done, are both healthy and capable of repaying the amount so borrowed on time.
- Where there is large outstanding / receivable from interconnected companies, the loan agreement needs to be thoroughly understood. The evaluator should ensure that the interest charged is as per industry standards and no undue advantage is given to the interconnected company. Other dimension which needs to be reviewed is the repayment schedule – whether the outstanding will be repaid back in instalment basis or lump-sum.
- In case of lump-sum, the bank needs to understand the capacity of the company to recover the outstanding from interconnected companies but, more importantly, they should also obtain the financials of the interconnected company with outstanding towards the former company (dealing with the bank). Obtaining financials will enable the evaluator to forecast the availability of cash flows in the interconnected company to honour the inter-group loan transactions on time rather than delaying the repayment.
- Banks should also see the cash flow of these transactions. The opening balances, additions and recoveries during the year should be seen to arrive at the closing outstanding. The trend of these outstandings should be seen to know whether the same is increasing,

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decreasing or steady. Average days of outstanding should be seen and compared with Industry outstanding average or average outstanding for other companies to see if there are no deviant or adverse terms. If the outstanding is due to a particular issue in dispute for quality or any other purpose, then the same needs to be noted and understood.

- The concern will be to ensure that such transactions are in the normal course of business operations and are done at arm's length. The significant outstanding may imply that the company may be facing a liquidity issue and may not be able to repay in a timely manner. The liquidity issue of 1 company should not affect the liquidity of the other company and in turn the liquidity issue should not turn out to be a solvency issue threatening the outstanding from the bank.
- If the significant outstanding is a temporary phenomenon or due to a quality or a particular issue that is resolvable over a period of time and does not threaten the liquidity or solvency then the same should be acceptable to the bank.

Conclusion: Bank should deep dive in depth for transactions with interconnected companies with a huge outstanding to ensure –

1. They are not book or adjustment entries to inflate Profits / assets.
2. Outstanding does not imply a liquidity or solvency issue which may lead to defaults, provisioning, NPA classifications and loan write-offs.
3. Underlying economic rationale is understood & transactions are done at arm's length pricing.

Signal No. 38. Substantial Related Party transactions

Sec 188 of the Companies Act gives directions on Related Party Transactions.

These contracts have to be at an arm's length basis i.e. without any conflict of interest as if both the parties are independent, willing & unrelated to each other and are pursuing their best interests.

These transactions have to be approved by the Board of directors at a duly convened meeting.

In addition to Directors' approval, a prior approval of members by means of a special resolution is also needed if,

1. The paid up share capital of the company exceeds Rs 10 Crores

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2. Sale, purchase or supply of any goods or materials directly or through appointment of agents exceeds 25% of the annual turnover
3. Selling or otherwise disposing of, or buying, property of any kind directly or through appointment of agents exceeding 10% of net worth

Related Party means –

1. A director or his relative or A Key management personnel or his relative
2. Any person on whose advice, directions or instructions, a director or manager is accustomed to act
3. A director or a Key managerial personnel in the Holding Company or his relative
4. A firm in which a director, manager or his relative is a partner or A private company in which a director or manager is a member or director
5. A public company in which a director or manager is a director or holds along with his relatives more than 2% of its paid-up share capital
6. A body corporate whose Board of Directors, managing director or manager are accustomed to act in accordance with the advice, directions or instructions of a director or manager
7. A Holding, Subsidiary or an associate Company

A subsidiary of a holding Company to which it is also a subsidiary

Every Related Party transaction or contract shall be disclosed in the Board's report along with the justification for entering into such contract or arrangement.

Every Company shall maintain one or more registers in Form MBP 4, and shall enter therein the particulars of contracts or arrangements with a Related Party with respect to transactions to which section 188 applies

Thus whenever any Related Party transaction is entered into, one should check adherence to the provisions of the Companies Act –

SA 550 deals with auditor's responsibilities in handling related party relationships & transactions while performing an audit of financial statements. This Standard highlights the higher degree of risks associated with such transactions due to the complexity of the way such transactions are structured, the complexity of the relationships & the fact that Information

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systems used may be ineffective in capturing the essence of the transactions reporting accurately the outstanding balances. The key phrase used in the Standard of Auditing is the ability to exercise significant influence or control.

This point may not be established by the Organization and hence such transactions could be unreported and go undetected

The key is to ensure that these transactions are conducted at fair market prices as if the parties were unrelated.

Care should be taken to ensure that these transactions are not done for profit looking adjustments with intent to avoid taxes or to increase turnover so as to get benefits of higher working capital limits –

One should see in depth whether there has been an actual underlying transfer of goods and services from one company to another accompanied by actual transfer of funds and these are not merely book entries to inflate profits / assets.

One needs to ascertain whether these transactions are in the normal course of business for purchase of goods or rendering of services which are done by one entity and needed by the other entity. The price at which the transactions are conducted should be at rates for both the entities with other parties for similar dealings in terms of quality and quantity.

The quantum of such transactions as a percentage to transactions with other parties also needs to be seen. If related party transactions are substantial then apart from a Concentration Risk, there exists a doubt as to the necessity & the genuineness of the transaction. Hence enquiries need to be done to satisfy oneself of the economic rationale underlying such transactions.

The trend in the quantum of such transactions over the previous few years could be seen to know whether the percentage is increasing or decreasing or steady.

Per se such transactions raise a Red Flag & need additional checks to satisfy oneself of the genuineness or economic rationale.

Transactions other than by way of Sales – Purchases or rendering of services i.e. by way of fund transfers say lending / borrowing need to be seen from **Funds Diversion** perspective also. Underlying rates of interest at which such transactions are conducted should be looked.

The company that is borrowing may not need funds but because of its strong financials or track record of repayment or managerial or business strength

Inter-Group/Concentration of Transactions

may be in a position to raise funds and that too at better rates of interest while a sister concern may not have that advantage. Hence funds could be borrowed by one entity and lent to another. In this case, either the transaction could be revenue neutral or could be done at a markup. In either case, one needs to ensure there is no unfair advantage or disadvantage to any company. The transactions should be fair and done at rates which at which it would have been done had there been no relation or connection between the two companies.

In cases of large business conglomerates with diverse interests or even in other cases, there could be instances where the services rendered by one company are needed by another company in the normal course of business. Hence if such transactions are done in the ordinary course and at prices charged to other companies, then the same is perfectly in order.

There could be cases where one company is a manufacturing company and the other Company may be a Sales / Distribution arm and either the entire or a substantial turnover could be sold to the company. In this case, there would be an underlying contract and reasons justifying the same. One needs to know the rationale to be satisfied as to the genuineness.

It is only when there is an ulterior motive or not an Arm's Length pricing that there is an issue.

Some examples could be –

1. Sales or profits in one company are falling and to beef up the same such transactions are conducted.
2. Profits in one company are high and to reduce tax burden such transactions are done.
3. If some benefits accrue if certain threshold of turnover / profits is achieved, then to achieve those thresholds, such transactions could be undertaken.
4. Maintain or increase share market prices.
5. Enhance eligibility for raising working capital limits from banks.
6. 1 company may have the financial ability to raise funds while the other company may not have the financial ability.

Substantial means of **significance** or **importance**.

The Companies Act needs prior approval of members by a special resolution if transactions exceed the prescribed percentage.

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Sec 2(32) of the Act defines substantial interest as holding by oneself or beneficially more than 20% of the voting power.

Thus one can conclude that any substantial transactions with related parties needs to be verified in depth for ensuring the same are conducted at arm's length and cause no disadvantage to either company. This needs to be seen as chances of collusion, manipulation and concealment may be possible in such transactions. Consideration entered into should be fair.

From a banker's or a bank auditor's perspective, one needs to firstly ensure that Related Parties have been correctly identified & post such identification there is no –

1. Fund diversion
2. Increase in eligibility of funds sanctioned / disbursed by such transactions which otherwise would not
3. Compromise in the Value of the securities charged to the bank
4. Double financing
5. Increase in the risk of default or increased credit risk
6. Ever greening / window dressing –misrepresentation of financial statements
7. Tax evasion or tax avoidance
8. Incorrect estimation or accuracy of the actual profits / turnover of the entity
9. Shift in the perception about the integrity of the borrower
10. Necessity to monitor the account more closely and have in-depth inspections
11. Non-compliance to the provision of the Companies Act or other applicable laws
12. Manipulation of share prices
13. Eligibility to Govt. or other benefits which one of them otherwise would not have been entitled to if not for such transactions

Section 6

Regulatory Concerns

Signal No. 39 & 40. Default in undisputed payment to the statutory bodies as declared in the Annual report & Raid by Income tax /sales tax/ central excise duty officials

Introduction

In the normal course of business, every borrower is required to pay one or more of the following payments to statutory bodies.

1. Income Tax
2. Value Added Tax (VAT)
3. Service Tax
4. Excise Duty.
5. Employee related dues such as Provident Fund, ESIC etc.
6. Customs Duty.
7. Luxury Tax, etc. applicable to specific business.
8. Other payments in nature of Duties, Taxes and Cess payable to Statutory Authorities.

All the above payments are guided by certain Acts, Rules and Regulations. Various powers have been assigned to the regulators governing the compliances of the payments.

Risk/Fraud Indicators/Source of Information

(i) Risks

Non-payment of statutory dues or non-compliance with any of the regulatory requirements may have impact on the working of the borrower which in turn may impact the operations in the Bank Account.

Chances are that the accounts have been manipulated. Either all the transactions are not accounted for or the transactions for accounted are not genuine.

(ii) Fraud Indicators

- (a) Frequent disclosures of income under amnesty schemes

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- (b) Frequent raids by concern regulatory departments
- (c) Non-payment of dues without any valid reasons

(iii) Source of Information

- (a) Financial Statements, Tax Audit Reports.
- (b) General/Market Information

Bank's Control- Prevention Or Detection

1. In-depth review of the Financial Statements including the Auditor's Report and Tax Audit Reports. In certain cases, Companies Act mandates the auditor to report on non-deposit of undisputed and disputed statutory dues.
2. Regular Stock Audits
3. Regular Inspections of the borrower.

Audit Process

- To review the financial statements of the borrower, the stock audit reports, the inspection reports, etc. to ascertain whether any of the indicators above prevail.
- Ensure that the bank officials have conducted necessary monitoring steps as per the policy, if any, on observing such indicators.

Case Study

- A borrower in service industry was enjoying a large credit limit of ₹400 crores. As per the financials, the turnover of the borrower was more than ₹ 1400 Crores. The service tax paid by borrower was only ₹ 40 Crores. Further, as per information available, there was also a raid at the office of the borrower by the Service Tax Department. 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.
- A borrower was enjoying credit limit of ₹ 100 crores. The turnover of the borrower as per audited financials was ₹ 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 ₹ 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

Signal No. 41. Disproportionate change in other current assets

1.	Introduction <p>The Bank advances against the Current Assets of the entity. It is called working capital finance. The working capital finance is given against Current Assets such as stock in trade or Receivables etc. The Current Assets include cash or cash equivalents, stock in trade, Account Receivables or any other advances. These are likely to get converted into the cash or cash equivalents during the period of working cycle. Since these Current Assets are moving as per the working of the entity, the Bank needs to monitor these Current Assets very closely. Hence, disproportionate change in the Current Assets is a cause of concern for lender Bank. Moreover, it could be an early warning signal for the Bank</p>
2	Risk / Fraud Indicators, Source of Information <p>In the following paragraphs, the indicators of Fraud or risk for Fraud are discussed</p> <ol style="list-style-type: none">1. The advance given to suppliers – It may be possible that the advance given is comparatively more, or pending for long time.2. Advance given to sister concern is represented as trade advance. It is likely to be diversion of Funds.3. Spike jump in stock in trade. It may be possible that the stocks are inflated without actual delivery of goods.4. Sudden increase in Receivables – It may be possible that the borrower may account for fictitious sales.5. Increasing trend in Export receivable without proportionate increase in the export sales. It may be possible that the foreign buyers are a related party.6. Increase in work in progress amount. This may be due to process failure or defective goods being produced7. The increase in amount of taxes paid or fictitious tax credit being produced.

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	<ol style="list-style-type: none"> 8. The increase in amount of taxes paid or fictitious tax credit being shown in the balance sheet. 9. Amount of Duty draw back or Export incentives receivable are increasing where there is thin certainty of recoverability. 10. Advances for expenses pending for a long time there is a possibility of postponement of accounting of Fixed Assets or Expenses.
<p>3.</p>	<p>Bank's Control - Prevention or Detection</p> <p>The Bank should review the Financial reporting of the borrower and try to get explanation for any irregularity noticed. Constant monitoring of the operations of the borrowers will save the bank from possible fraud in future.</p> <p>The following are certain measures or precautions:</p> <ol style="list-style-type: none"> 1. Bank should obtain periodic statements of purchases, sales, Payables and Receivables and scrutinise them appropriately. 2. The Bank should compare the turnover in the account with the Periodical Statements submitted by the borrower. 3. Related Party transaction disclosure in the Financial Statements should be studied and the transfers to related parties should be questioned appropriately 4. Stock Statement submitted should be studied and slow or non-moving stock should be identified. 5. Age wise analysis of the Receivable should be obtained and long outstanding receivables should be identified. Especially, receivables from foreign parties are to be monitored. 6. The working cycle of the borrower should be studied and work-in-progress to be monitored to see that it is at reasonable level. 7. Claims for incentives accounted for on accrual basis should be verified with the documents in order to ascertain their reliability. 8. Taxes paid and the tax demands should be studied to identify fictitious taxes or credits shown as receivables.
<p>4.</p>	<p>Audit Process</p> <ol style="list-style-type: none"> 1. The auditor should ascertain whether there exists the process of obtaining documents and monitoring the account accordingly. 2. The auditor should study the memorandum of proposal and account operations of the borrower account and try to study the

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	<p>statements submitted by the borrower and see whether there exists any early warning signal for fraud or for account turning into non- performing Account (NPA).</p> <p>3. The auditor should question the dealing officer of the Bank who had visited the office / factory / godown of the borrower and his understanding of the situations.</p> <p>4. A table should be made for the disproportionate change in the current assets as compared to earlier years and also compared to industry norms. The elements resulting in such increase should be analysed in detail and acted upon.</p>
5.	<p>Conclusion</p> <p>A proactive action from the Bank or the auditors will save the loan account from becoming NPA or from fraud. Therefore, the bank should analyse the statements submitted by the borrower. The inspection of securities should be carried out systematically and with proper regularity.</p>

Signal No. 42. Resignation of the key personnel and frequent changes in the management

1.	<p>Introduction</p> <p>The business of an entity is run by its key management personnel in order to have consistency in the business strategy of the concern. The success of the business is dependent on its management team, especially the technical and management skills of the key management personnel, their business ethos and business strategy etc. Therefore, frequent change in the management is an early warning signal to the bank regarding credit risk.</p>
2.	<p>Risk / Fraud Indicators / Source of Information</p> <p>1. Resignation of key management personnel or frequent changes in the management will lead to following risk or fraud indicators.</p> <p>2. The Financial health of the entity is deteriorating. Due to this, the top management personnel may leave the entity.</p> <p>3. It is likely there is a dispute in the management team about continuation of the line of business which is likely to be called as illegal business or the activity which is likely to give rise to reputation risk, e.g., import of banned goods.</p> <p>4. There could be certain operational deficiencies which will lead to</p>

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	<p>losses or liability in future. In such a situation, some management executives are likely to resign.</p> <ol style="list-style-type: none"> 5. The contracts entered into by the entity are not likely to be beneficial to the entity. Such contracts may create liability for the management team. 6. It is likely that the financial condition of the entity is such that it is not able to attract the appropriate talent from the market. Hence the incoming personnel stay for a short period. 7. The transactions with the entities which are entered into after the exit of some personnel should be seen. There is a possibility that the person did not want to categorise such transactions as Related Party Transaction. Hence he resigns first and then enters into a contract for the said transaction.
<p>3.</p>	<p>Bank's Control – Prevention/ Detection</p> <p>The Bank should be alert enough to keep up with the changing situation in the management. Hence, it should develop proper management information system (MIS) so that reacting to such events becomes easy for the Bank.</p> <ol style="list-style-type: none"> 1. The details regarding share holding pattern given in the Financial Statement should be studied and monitored. 2. The Annual Report and copy of the Annual Return should be obtained and verified for the extent of change in management. 3. The Bank should verify the details on the website of Ministry of Corporate Affairs (MCA) to understand the composition of Board and other details about the company. 4. The periodic statements submitted by the borrower and the account operations should be studied and it should be ensured that they are in sync with each other 5. The Financial position of the entity and the contract entered into by the entity in recent past should be studied to find out if there is any possibility of fraudulent transactions. 6. The Bank should also study the history of the incoming management personnel and carry out the background check properly. 7. The Bank should also look at the condition of personal guarantee of the directors or management personnel's so that no one escapes which may result in loss to the Bank.

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4	Audit Process <ol style="list-style-type: none">1. The auditor should study the documents which are on record and carry out its independent analysis to ascertain whether there is a possibility of any fraud or loss to the Bank.2. The auditor should review the documents to verify whether the personal security was there with the resigning person. This may cause deterioration in the value of the security.3. The auditor should use his commercial information to understand the reason behind change in the management.4. The auditor should use external sources of information such as websites, social sites, annual reports, Annual Returns submitted to understand the change in the line of business, financial healthy, Legality of business activity etc.5. The auditor should also see the background check for the incoming person in the management team.
5	Conclusion <p>When there are frequent changes in the management, it should be considered as a firm early warning signal for credit risk. Hence, the Bank as well as the auditors should be alert enough to take cognisance of such a situation. A proactive step in this regard may save the Bank from future losses.</p>

Signal No. 43. Significant reduction in the stake of promoter /director or Increase in the encumbered shares of promoter/director

1.	Introduction
	<p>While financing for the business of the company, the Bank would always like to study the pattern of promoter's stake holding. When the holding of the promoter is high, it shows that the promoter is ready to share the risk of the business. When the share of promoters' holding reduces it becomes a cause for concern for the bank. Similarly, if the promoter pledges his shares, it shows that the capacity of the promoters is limited / reduced causing concerns to the lenders. Hence the Bank should keep an eye on the promoter's stake in the company.</p>

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2.	Risk / Fraud indicators / Source of Information
	<ol style="list-style-type: none"> 1. When the promoters' stake starts reducing, it is an indicator that the willingness of the promoter to share the risk has also reduced. Hence such instances should be reviewed closely. 2. The information on the website of the Ministry of Corporate Affairs (MCA) should be scanned regularly. Similarly, in case of the listed company the corporate action also needs to be studied. 3. There could be a possibility that the stake of the promoters gets reduced due to issue of capital. In such a situation, the reasons for issue of additional capital and the funding of the project should be studied. 4. In case of mergers and business reorganisation, the promoter's share is likely to be diluted. The merger agreement, shareholders' agreement should be studied thoroughly in this regard. 5. The fluctuation in the market value of the shares around the transfer needs to be seen. 6. In case of private equity Fund Investment the pricing of shares transferred needs to be seen. The bank should compare the price and understand the future projections given.
3.	Bank's control – Prevention or Detection
	<p>The bank should be alert enough to keep up with the position of transfer of shares or any change in the shareholding pattern.</p> <ol style="list-style-type: none"> 1. The website of the borrower or MCA should be reviewed periodically. 2. The borrower should ask promoters and company to intimate the change in the shareholding pattern – this should be one of the conditions for the sanction and the same should be monitored strictly. 3. In case of listed company, the bank should see the corporate actions from the website and ensure that there is no dilution in the shareholding of the promoter.
4.	<p>Audit Process</p> <p>The auditors should review the aspects stated in the above paragraph and try to understand whether there are proper reasons for reduction in the stake of promoters or pledging their shares. If not,</p>

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	<p>those cases should be analysed in greater detail.</p> <ol style="list-style-type: none">1. The auditor should also try to study the agreement and other documents to understand the terms of contract for transfer of shares or terms for issue of additional shares.2. The auditor should see that the value of the security is not impacted adversely by any transaction which leads to reduction in promoters' stake.3. The auditor should be watchful for other commercial information which is likely to impact such situations. He should sound the same to the Bank Management.
5.	<p>Conclusion</p> <p>The Bank should be alert enough to understand the implications of any action which reduces the state of the promoters. Even if it is due to expansion like business reorganisation or strategic investment, the same needs to be studied properly. The Bank should safeguard its interests and avoid the credit risk.</p>