Sixth Sense

Audit Risks and Frauds Risks & Statutory Auditor Safeguards

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- Overall Landscape
- Role of Statutory Audit in Frauds in Financial Statements
- Component Wise Red Flags

sixth sense (meaning)

“a supposed intuitive faculty giving awareness not explicable in terms of normal perception”

Overall Landscape and Changes

Economic Stress which is amply evident

MCA Strike off of over 3 lakh Companies and Dormant Companies

Usage of Corporate Vehicle as Shell Companies

OTS and IBC

Overall Landscape and Changes

NFRA View on Audit

LODR Changes

Usage of Corporate Vehicle as Shell Companies

Perception of an Auditor

Overall Landscape and Changes

Section 143(12)

ICOFR

New CARO

New Schedule III

Statutory Auditor

Notwithstanding anything contained in this section, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts <u>as may be prescribed</u>, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner <u>as may be prescribed</u>:

Defining Frauds

"fraud" in relation to affairs of a company or any body corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss;

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

Role of Statutory Auditor

- SA 240, inter alia, states the following: Paragraph 5 - ‘An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.’
- Paragraph 40 - ‘If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities’.

Guidance Note on Fraud Reporting

Reporting Responsibility	All Auditors – Statutory, Cost and Secretarial
Threshold and Materiality	> Rs 1 Crore and Less than Rs 1 Crore
Exclusions	Kick backs, Stolen Passwords, Parallel Business
Category	Auditor Comes Across
Previously Discovered frauds in the same Financial Year	Only when he comes across and not previously discovered frauds
Frauds of Previous Financial Years	Auditor to apply professional skeptcism

Guidance Note on Fraud Reporting

Is Conclusive evidence needed	Reason to believe is the criteria
Bribery, Money Laundering and Non-compliance with other Laws and Regulations	To be read with Sec 147(2) on Auditors Penalties

Fraudulent Transactions

Sensors - Sixth Sense

- Public Domain information
- MCA website
- Income tax
- GST
- Enforcement Agencies
- Other Scent Receptors

Components of the Financial Statements

- Possibility of Fraudulent Transactions need to be reviewed across all parts of the financial statements – Balance Sheet, Profit and Loss Statements , Cash flow statements.

- All components of the financial statements – Assets, Liabilities, Incomes and Expenses, Contingent liabilities can be impacted by such transactions resulting in loss of value to the Corporate Debtor which the Auditor is expected to report on

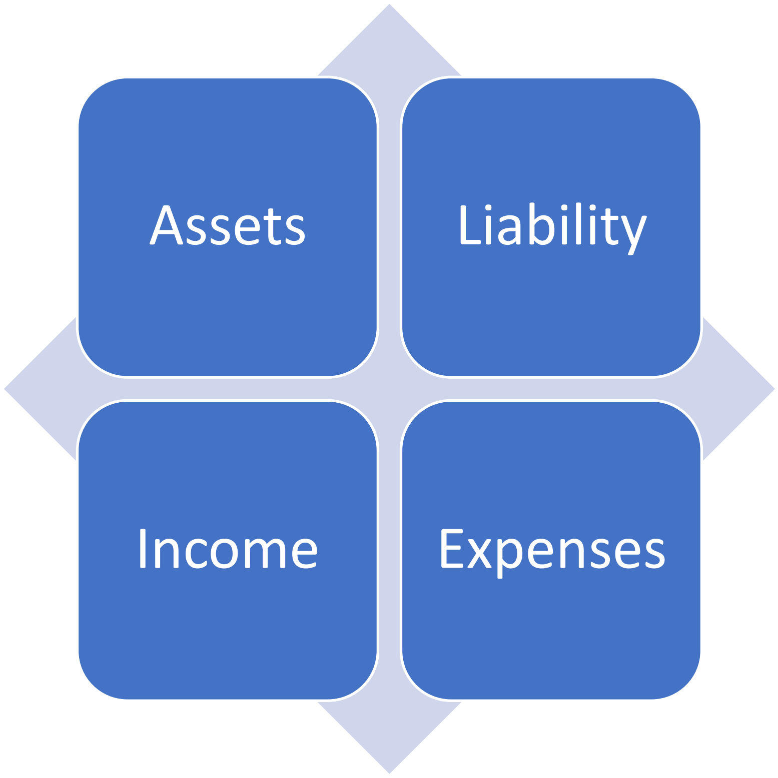
Components of the Financial Statements

Sources of Funds

- Share Holders funds
- Secured Borrowings
- Unsecured Borrowings

Application of Funds

- Fixed assets
- Investments
- Inventories
- Working capital (Current Assets less Current Liabilities)
- Loans and Advances



Common Scenarios

Share Capital

- Share Capital not received by bank funds process but by fraudulent adjustment entries
- Later transferred back to related entities

- Exorbitant Share Premiums from investors companies again not through bank sources or diverted back later

- The very share capital has been brought in through a maze of investors to whom funds have been provided by the Company

- Share holding is fictitious - Share holders have themselves extinguished the investments in their Balance Sheets (Shell Companies are investors)

- Company funds have been used to purchase shares of the Company by directors

Non-existent Share capital has been used as leverage to obtain bank / other loans fraudulently

Common Scenarios

- Loans recorded by mere book entries without corresponding bank inflows – Preference / Fraudulent

- Round Tripping Loans received diverted to other group / connected entities without any business purpose – Diversion of funds

- Loans taken without No objection from existing lenders and security interest created thereon –

- Unsecured loan becomes an Secured loan without new value

- Loans stated as received in Cash but not properly reflected in books of accounts or charge created

Secured Loans

Non-existent Share capital has been used as leverage to obtain bank / other loans fraudulently

Common Scenarios

Secured Loans

- Certain loans settled in priority over some other loans

- Loans received at exorbitant rates of interest or security created

- Stated as Secured loan by unregistered MoDTD and ante dated transactions

- Where loans have been recognized due to invocation of bank guarantees, where such BG did not reflect genuine business transactions

Security interests and claims recognized on basis of award by Court or Tribunal

Common Scenarios

Secured Loans

- Sudden Conversion of unsecured loan to secured loans in order to defraud the other secured creditors

- Promoters
- Directors
- Lender
- Bankers

Common Scenarios

Unsecured Loans

- Loans recorded by mere book entries without corresponding bank inflows (Fraudulent)

- Loans received diverted to other group / connected entities without any business purpose

- Loans at exorbitant rates of interest or prepayment of interest

- Loans stated as received in Cash and admitted by the IP

- Where loans have been recognized due to invocation of bank guarantees, where such BG did not reflect genuine business transactions

Common Scenarios

- Fictitious purchases of goods and services and consequent liabilities and losses

- Transactions especially with Related Parties not on an Arms Length basis

Sole Selling or Purchase agents Sales and Purchase Contracts

- Creditors settled directly by customers but still showing as outstanding both for receivables and payables

Purchases and Current Liabilities

Common Scenarios

Fixed Assets

- Assets used by other entities on a free of cost/ lower than charge basis

- Sale and Lease back transactions of assets pledged in favor of lenders

- Un-authorised creation of security interests (SC : JAL judgement)

- Assets used for personal purposes of promoters and cost borne by Company

- Undervalued sale of assets without valuation reports / competitive sale process resulting in erosion of value

Common Scenarios

SPV / Business Divisions

- Incorporation of SPV and transfer of funds to such entities

- Indian SPV subject to strike off and loss of trail of funds

- Foreign SPV closed without notice to lenders and no trace of funds moved and utilization

- Creation of assets abroad
- Creation of assets in related entities

- Sale / Transfer of business divisions or segments which are key revenue earners

Common Scenarios

Investments

- Funds - Investments in connected / related entities with no business purpose without lender consent for diversion

- Shares of entities purchased as investments at exorbitant / unjustified premiums

- No return on investments in terms of dividends or refund of capital even after long periods of time

- Large Investments extinguished / written off and recorded as losses without proper rationale and eroding the net worth

- Shares holding diluted by fraudulent & / Collusive rights issues process and relinquishments by CD in investee companies

Common Scenarios

Inventories

- No records of is maintained and hence loss of visibility
- Massive write offs of inventories

- Undervalued & / or Alienation / Sale of inventories and fund routed through other bank accounts and not the designated accounts

- Evergreening of operational creditors by defective return processes

- Inventories used for personal/ other related entities purposes of promoters and cost borne by Company

- Inflated stock and book debts reporting without any underlying inventory

Common Scenarios

Receivables

- Fraudulent accounting and reporting of sales and inflation of receivables
(EPC companies)

- Customer payments are made directly to vendors / promoters and receivable balances are shown outstanding

- Large receivables extinguished / written off and recorded as losses without proper rationale/ legal efforts and eroding the net worth

- Fictitiuos Bank receipts (in bank book but not in bank statements)

- Undervaluation

- Leverage Sales figure to obtain bank funds fraudulently

Common Scenarios

Advances

- Loans and Advances given without any agreements and legal recourse
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- Loans to directors / entities for no business purpose and includes related / connected entities

- Loans and advances on an interest free basis although interest is paid by the CD

- Large Loans and advances written off without any legal recourse / attempts to collect and eroding the net worth

- Loans and Advances balances outstanding in strike off entities and no proceedings are possible
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Common Scenarios

P&L Items

- Inflation of Sales Revenues

- Payroll Frauds

- Fictitious Expenses
- Related party purchases
- Accomodation purchases

- Bribes masked as genuine Business Transactions

- Capital Vs Revenue Expense

Thank You