

Nature & Classification of Financial Frauds

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Jointly organised by Nalsar University of Law & Truth Labs

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Economic Offence

A Crime, the sole objective of which is to simply

- accumulate money,

- wealth or

- illicit profit

at the cost of gullible public by

- exploiting the loopholes in the system,

- misusing the opportunities extended by the State to its citizens for their economic prosperity and by

- violation of established regulations and fiscal laws

General Characteristics of Economic Offenders

- Perpetrators are educated, intelligent and often well placed in society.
- Well-versed with the system and its vulnerabilities and loopholes
- Predominantly, the victim is the whole society and not the individuals
- No significant social stigma is attached by the society present day
- Operations are technical and complex in nature.
- Not limited by geographical boundaries

What is Fraud

Black's Law Dictionary

Fraud consists of some deceitful practice or willful device, resorted to with an intent to deprive another of his right, or in some manner to do him an injury. As distinguished from negligence, it is always *intentional*.



Elements in Fraud

1.Victim

2.Victim Loss

3.Perpetrator

4.Deceptive Act

5.Evidence that perpetrator acted with an intent

6.Evidence that perpetrator profited by the Act

Economic Offence/Frauds

- Broad Classification

– BY INSTITUTIONS AGAINST INDIVIDUALS

Window dressing, Ever greening, Diversion of funds, Bogus expenditure, Layering black money, Share market frauds, levying concealed / frivolous charges using technology, ambiguous / illegible terms & conditions.

– BY INDIVIDUALS AGAINST INSTITUTIONS

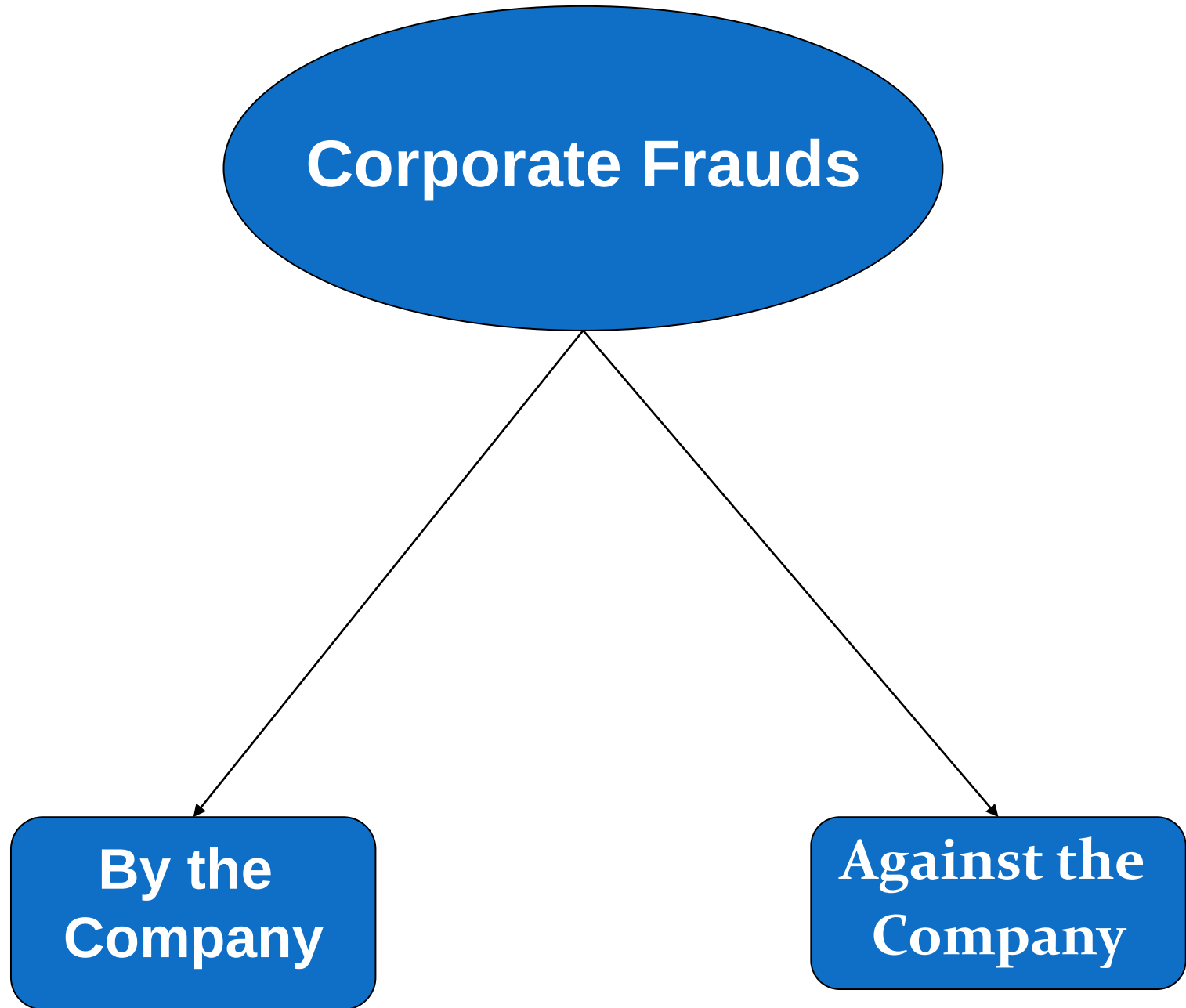
Bogus Loans, Multiple loans, Diversion of funds, False insurance claims, Credit card frauds, LC frauds, Frauds with bogus identification and fabricated documents.

– STATUTORY VIOLATIONS / TAX EVASIONS - BY BOTH INSTITUTIONS AND INDIVIDUALS

Direct & Indirect taxes evasions, Power theft, False claiming of exemptions, Money Laundering etc.

Kinds of Frauds/Economic Offences





Corporate Frauds Classification

Financial Statement Fraud or Accounting Fraud

- Falsifying Financial Information by fudging the books, thereby misleading the investors/bankers/suppliers/Govt/other users

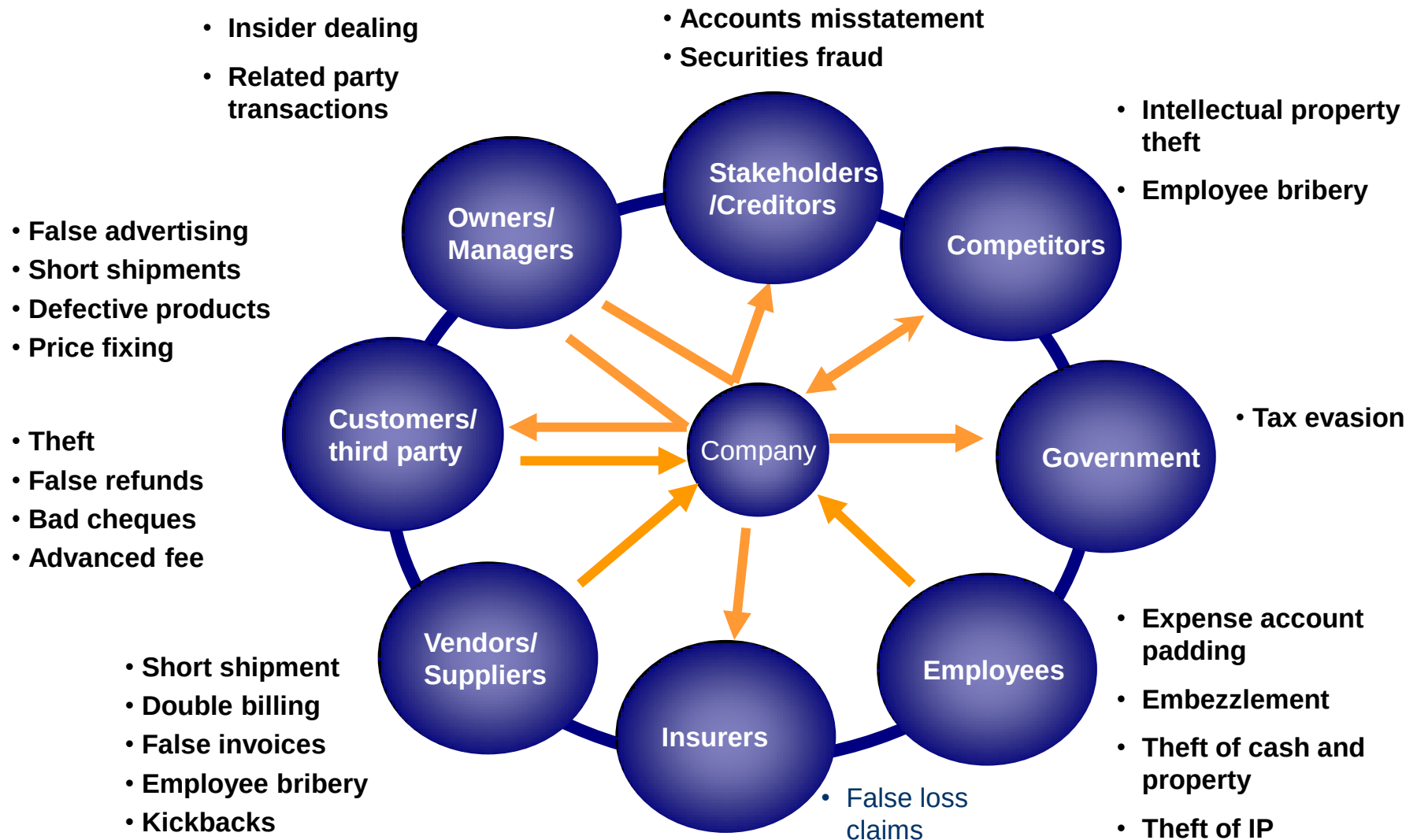
Self-dealing by Corporate Insiders

- Misappropriation of corporate assets by senior executives
- Loans granted to Senior Mgt that are never intended to be repaid
- Failure to disclose loans waived off
- Reimbursement of personal expenses charged to the company
- Insider Trading
- Misuse of Corporate Property for personal gain

Obstructive Conduct

- Falsifying testimony to regulators, erasing computer files, shredding documents, creating or altering document to support illegal conduct

Who is Defrauding Whom?



Fraud Tree



Frequency- 85%
Avg. value-\$130,000

Asset
Misappropriation

Cash

Theft

Cash Receipt Theft

Fraud
Disbursement

Other Assets

Misuse

Theft



Frequency- 37%
Avg. value-\$200,000

Financial
Statement
Fraud

Revenue/Asset
Overstatements

Revenue/Asset
Understatements

1. Percentages do not add to 100 because Frauds Overlap over multiple categories
2. Longer it takes to detect the higher the loss

Frequency- 8%
Avg. value-\$1,000,000

Corruption

Bribery

Illegal Gratuities

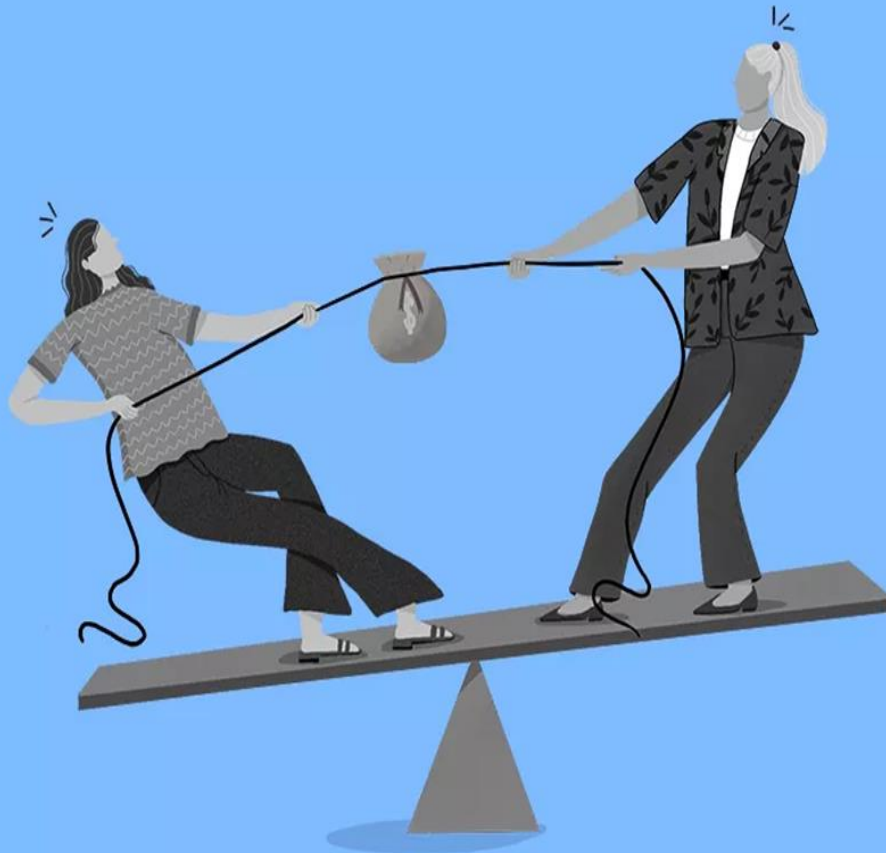
Conflict of Interest

Economic
Extortion

- Representing a family member in court
- Starting a business that competes with your full-time employer
- Advising a client to invest in a company owned by your spouse
- Hiring an unqualified relative/friend

Conflict of Interest

['kän-,flikt əv 'in-t(ə-)rəst]



A situation in which an entity or individual becomes unreliable because of a clash between personal (or self-serving) interests and professional duties or responsibilities.

Why **GOOD PEOPLE** do **BAD THINGS**

The Fraud Triangle:

A framework for spotting high-risk fraud situations



Large Scams in India

- Nirav Modi
- 2G Spectrum
- Common Wealth Games
- UP NRHM
- IPL
- Madhu Koda Mining
- Satyam Scandal
- Coalgate (Coal Scam)
- Vanishing Companies
- Bank FDR's Scam
- Agri-Gold
- Bellary Mines

- Antrix Devas Deal
- Chopper Deal
- Tatra Scam
- Fodder Scam
- Ketan Parekh and the Stock Market
- Harshad Mehta
- Adarsh Housing Society
- Bofors
- Hawala
- Sharada Chit Fund (W.B)
- King Fisher Airlines

..... List goes on

Growing Complexities leading to Fraud and Manipulations



Types of Corporate Frauds

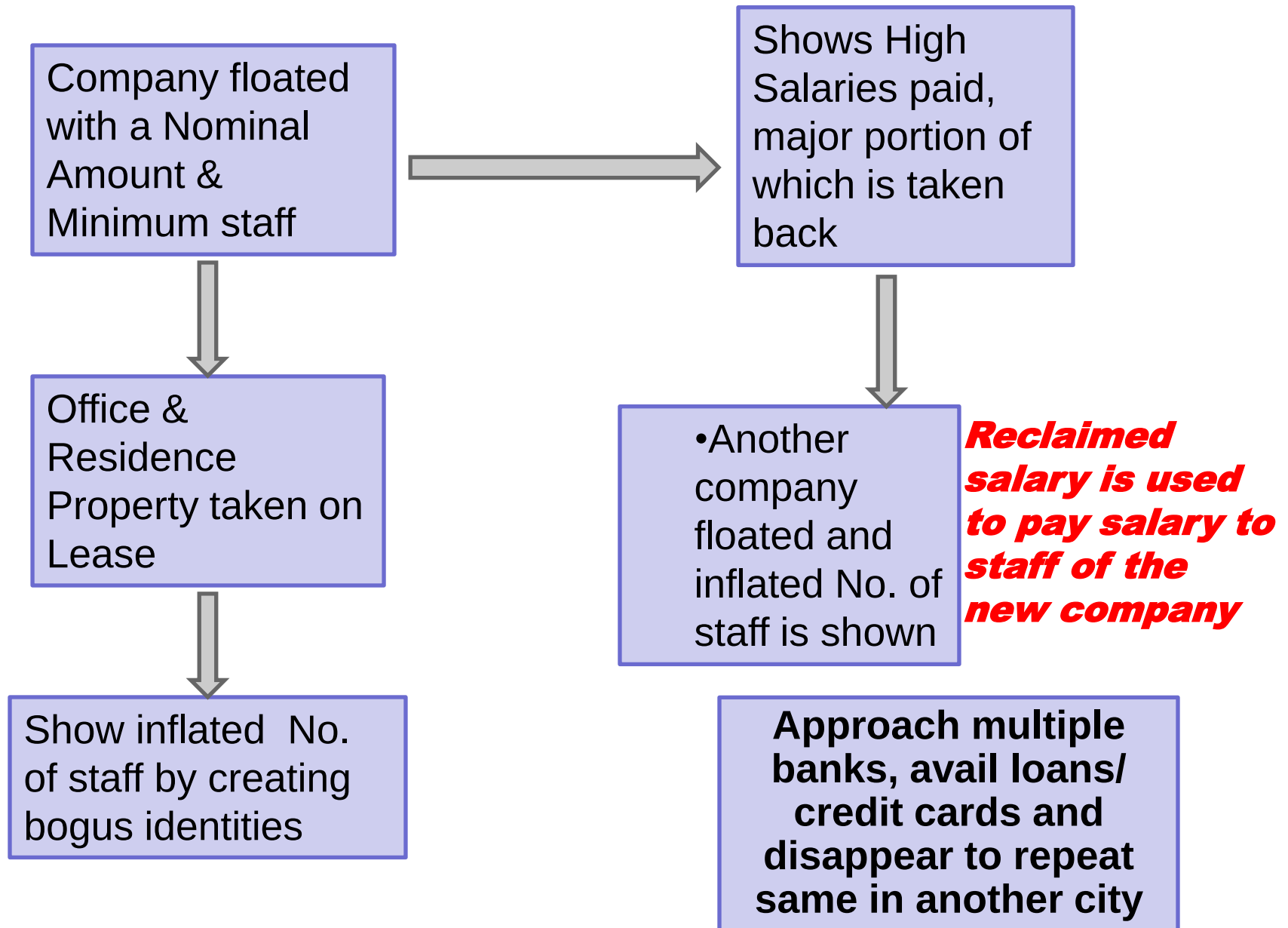
- Bank Loan Frauds & Tax Evasion Frauds
- Bogus Asset Creation
- Recycling / Evergreening
- Share Price Manipulations by inflating revenues
- Non-Refund / Diversion of Public Deposits / Bank Funds
- Financial Statement manipulations
- Hiding liabilities
- Assets Stripping

Corporate Setup for Retail Frauds

- Corporate Setup being used to gain respectability and size within a short period of time, e.g. NBFCs & Share Market Manipulations
- Corporate Setup is being used to either directly indulge in manipulations / fraudulently declare data or increasingly used to establish SETUP COMPANIES making them eligible by recycling the turnover and also making a list of eligible employees who are not eligible for any loans

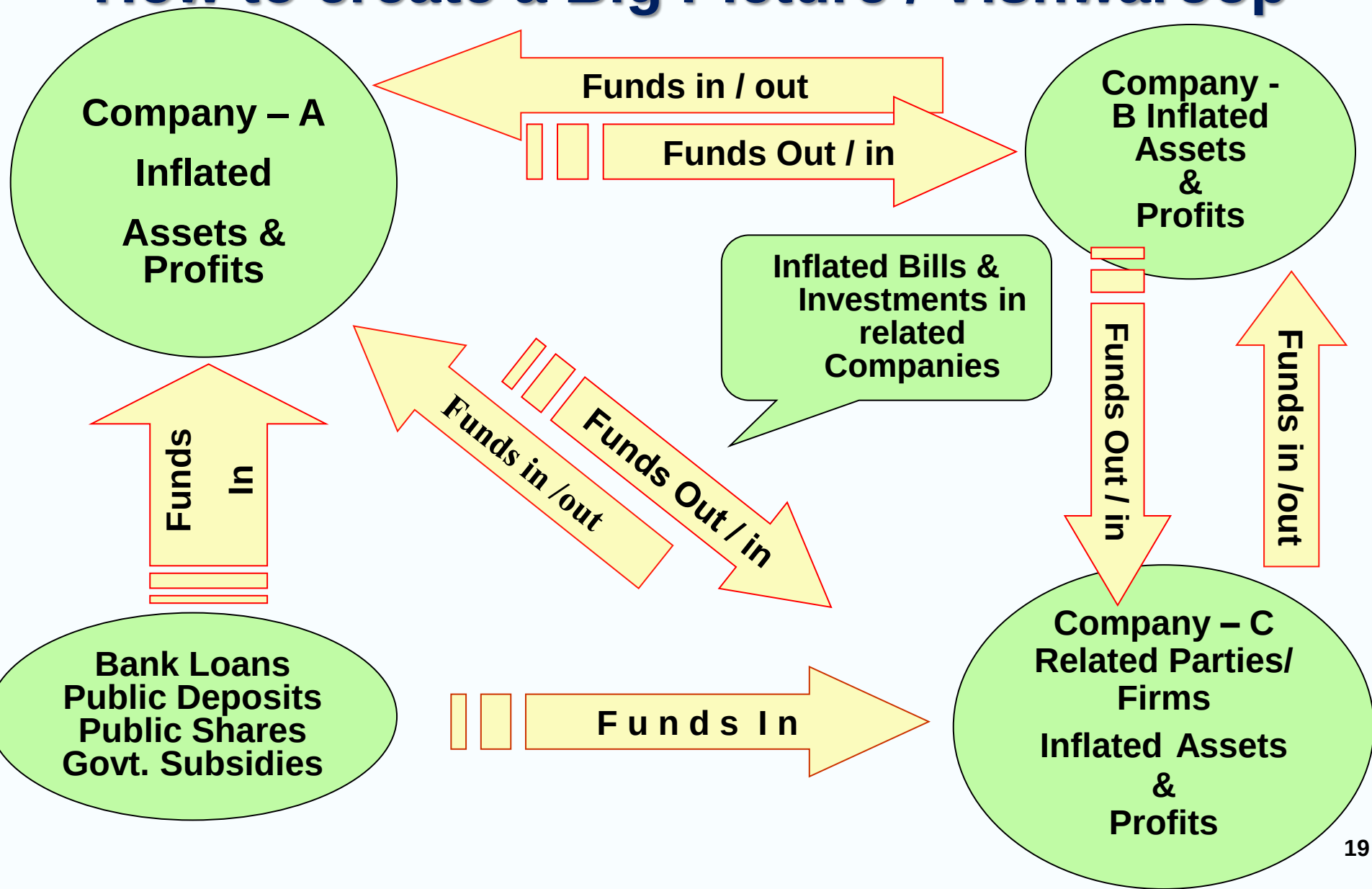
E.g. - Trigger is different dates for payment of salaries

CORPORATE SETUP FRAUD



Corporate Frauds – Round Tripping / Recycling

How to create a Big Picture / Vishwaroop



Common Methods of Manipulations

- **Window Dressing**

Manipulation of financial statements to camouflage the real position of a company to show a better position

- **Evergreeing**

Keeping the repayment schedules of loans / deposits in order by borrowing/ accepting additional loans / deposits

- **Recycling / Round Tripping of Funds**

Reusing the same money to create or show that much higher quantum of money has come in through different sources and many times

- **Bogus Asset Creation / Expenditure booking**

Normally used for diversion of funds or for Loan disbursal eligibility

Inflating Assets

Objectives

- ✦ Higher Govt. Capital Subsidy
- ✦ Higher Return on capital promised by Govt. to encourage investments in specified industries, viz. Power Sector.
- ✦ Higher eligibility of Bank Loans & Bogus Insurance claims
- ✦ To meet margin requirement of bank loans and make Balance Sheet look artificially healthy and strong

Methodology

- ✦ Inflating Plant & Machinery bills, Technical Knowhow, Contract bills, Inflated imported equipment from related parties, Bills from bogus firms
- ✦ Huge bogus investments routed through accounting malpractices, enhanced capital cost & claiming additional minimum return on capital of Rs.100Cr (Approx) from State Electricity Boards
- ✦ For Finance Companies, to circumvent existing provisions of law, Camouflaged Bogus Asset Based Loans are given
- ✦ Ever greening : Re-cycling limited capital & avoid NPA regulations

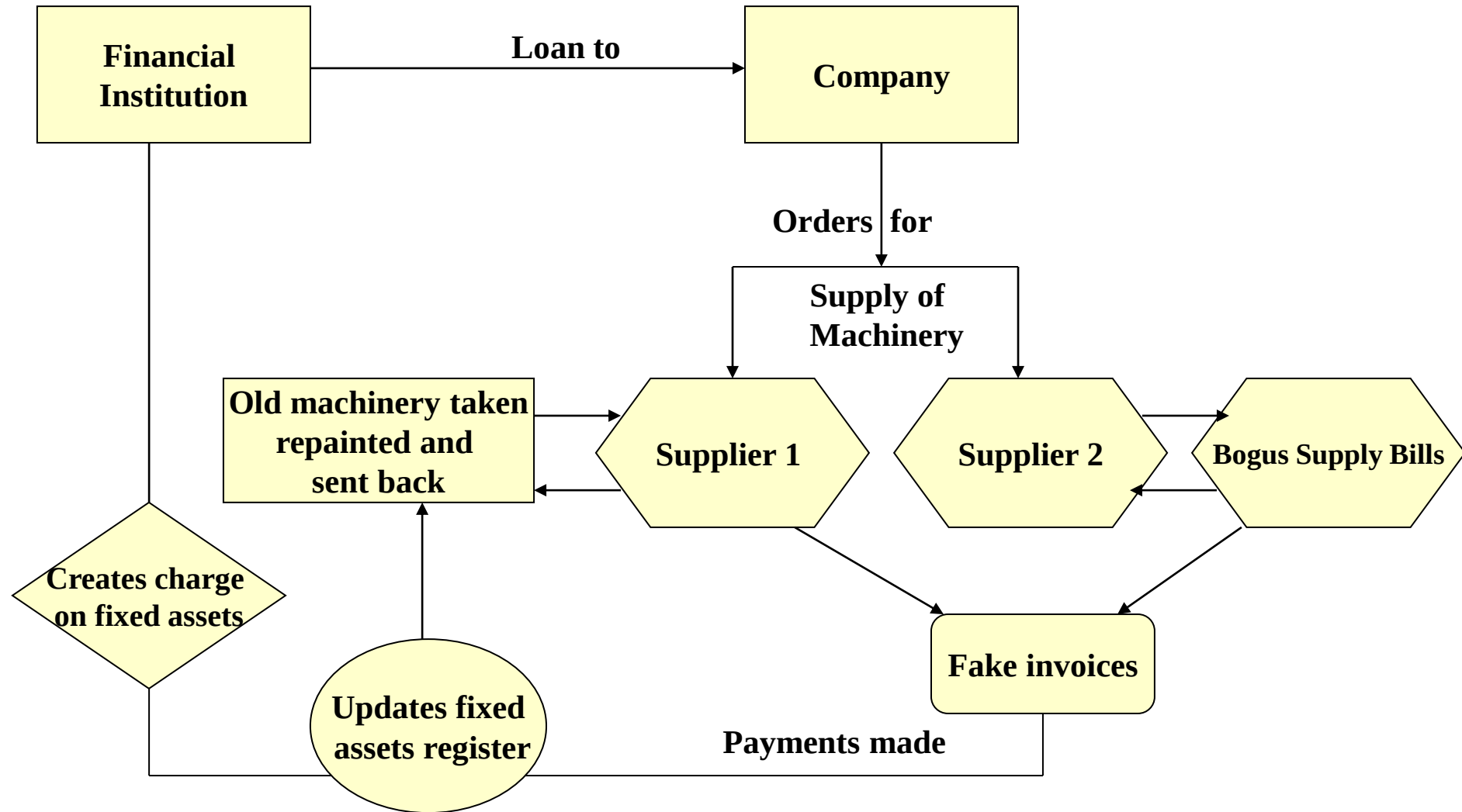
Impact on Financials

- *Higher Fixed Assets base – Higher Total Assets = Higher Depn/Subsidy, higher bank loan eligibility without margin money*

Various FS Manipulations

Methodology used	What do Companies Achieve?	How Done
Inflating or Bogus Expenses / Hiding Sales	Funds from issue of shares, public deposits/schemes/Bank loans are diverted for personal use Wrong claim of GST input Show Promoters' Contribution	Booking Fictitious Expenses / Contracts, Ghost Employees/Staff, Consultancies, Huge Foreign Travel, GST malpractices Money Laundering
Inflating Profits	Higher Bank Loan eligibility Enriching at the cost of investors	Window dressing accounts Reporting fake transactions through sister/group entities
Concealing Liabilities	Get better rating/loans Getting Higher credibility	Creating contingent liability for real liabilities Showing liabilities as Income Showing USL as CAPITAL
Off Balance Sheet items	Hide Real liabilities by showing them as 'Off Balance Sheet items' Significant where company applies for Bank Loans (D/E Ratio)	Guarantees given, LC's issued are not shown/disclosed Similarly, litigation cases impact not disclosed/shown

Asset Manipulation - Company



Asset Inflation-Bank Fraud Case

- ✦ Present Loan account running irregularly
- ✦ Approached Bank for additional limit for Generator purchase on proposal that certain portion be adjusted for making loan 'regular'
- ✦ On other hand, drawn certain physical cash as Advance
- ✦ Originally went to one place & selected 2nd hand Generator and also coordinated with Refurbishing dealer to make the Generator look NEW
- ✦ Went to another dealer & negotiated for bill without Generator
- ✦ Spend the moneys for Generator, Bill & Transportation and incidental costs
- ✦ Produced bill with Banker and got the amount disbursed directly and also adjusting old outstanding dues and making account 'regular'
- ✦ Using cheque discounting parties/agents, got the amount back, which was used for personal purposes of Director
- ✦ The cycle is complete – order placed, Asset received & created
- ✦ The actual value of the Asset is hardly 10-15% of the invoiced value and the party was successful in defrauding the Bank

**THE PROBLEM WITH
BALANCE SHEETS
NOWADAYS IS THAT
ON LEFT SIDE,
THERE IS NOTHING RIGHT
AND
ON THE RIGHT SIDE,
THERE IS NOTHING LEFT**

Balance Sheet as on 31.03.2017 – Actual Figures

Particulars		Amount (INR)
LIABILITIES		
I. Capital	4,500,000	45,00,000
II. Reserves & Surplus	1,000,000	10,00,000
III. Non Current Liabilities		
Secured Loans- Term Loan	7,000,000	
Unsecured Loans	4,000,000	1,10,00,000
IV. Current Liabilities		
Working Capital Loan	2,400,000	
Trade Payables	2,000,000	
Short term provisions	700,000	
Other Current Liabilities	900,000	60,00,000
TOTAL		2,25,00,000
ASSETS		
I. Non-Current Assets		
Land & Building	6,000,000	
Plant & Machinery	5,800,000	
Cap-Exp Advance	4,000,000	1,58,00,000
II. Current Assets		
Inventory	1,600,000	
Trade Receivables	2,500,000	
Cash & Bank Balances	2,600,000	67,00,000
TOTAL		2,25,00,000

Ratios	
Debt	11,000,000
Equity	4,500,000
Debt Equity Ratio	2.44
Total Outside Liabilities	17,000,000
Total Net worth	5,500,000
TOL/TNW Ratio	3.09
Current Assets	6,700,000
Current liabilities	6,000,000
Current Ratio	1.12

Impact of Manipulations

Changes made

Impact

LIABILITIES SIDE

Actual Unsecured loan is Rs.40,00,000

Of this, Rs.30,00,000 is now 'shown' or 'manipulated' as Share Capital

Net Worth increased, better Debt Equity Ratio

Healthy improvement in Current Ratio

Good TOL/TNW Ratio

ASSETS SIDE

Actual CAPEX was Rs.40,00,000.

Out of this, Rs.20,00,000 is reduced and

- ✓ Inventories increased by Rs.10,00,000
- ✓ Receivables increased by Rs.10,00,000

Significant improvement in Current Ratio

If Working Capital limits availed, better Inventory and Trade Receivables; Healthy numbers

Balance Sheet as on 31.03.2017 – After Manipulation to suit Eligibility

Particulars		Amount (INR)
LIABILITIES		
I. Capital (+)	7,500,000	7,500,000
II. Reserves & Surplus	1,000,000	1,000,000
III. Non Current Liabilities		
Secured Loans- Term Loan	7,000,000	
Unsecured Loans (-)	1,000,000	8,000,000
IV. Current Liabilities		
Working Capital Loan	2,400,000	
Trade Payables	2,000,000	
Short term provisions	700,000	
Other Current Liabilities	900,000	6,000,000
TOTAL		22,500,000
ASSETS		
I. Non Current Assets		
Land & Building	6,000,000	
Plant & Machinery	5,800,000	
Capex Advance (-)	2,000,000	13,800,000
II. Current Assets		
Inventory (+)	2,600,000	
Receivables (+)	3,500,000	
Cash & Bank Balances	2,600,000	8,700,000
TOTAL		22,500,000

Ratios, post manipulations

Debt	8,000,000
Equity	7,500,000
Debt Equity Ratio	1.07
Total Outside Liabilities	14,000,000
Total Net worth	8,500,000
TOL/TNW Ratio	1.65
Current Assets	8,700,000
Current liabilities	6,000,000
Current Ratio	1.45

Warren Buffet sums up
EARNINGS MANAGEMENT

as

Management that always promise to

MAKE THE NUMBERS BIG

will at some point of time,

MAKE UP THE NUMBERS

LEADING TO MANIPULATIONS

Any Questions / Clarifications?

Thank You

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