Nature & Classification of Financial Frauds

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Defining Economic Offence

A Crime, the sole objective of which is to simply accumulate money, wealth or illicit profit at the cost of gullible 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 can be broadly categorized as Economic Crime.

General Characteristics of Economic Offence cases

- Perpetrators are educated, intelligent and often well placed in society.
- Knows the system well.
- Mostly individual is not the victim, whole society is the victim.
- No social stigma attached.
- Technical, complex in nature.
- Not limited by geographical boundaries

Economic Offences & Frauds
- Broad Classification

- **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.

- **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**

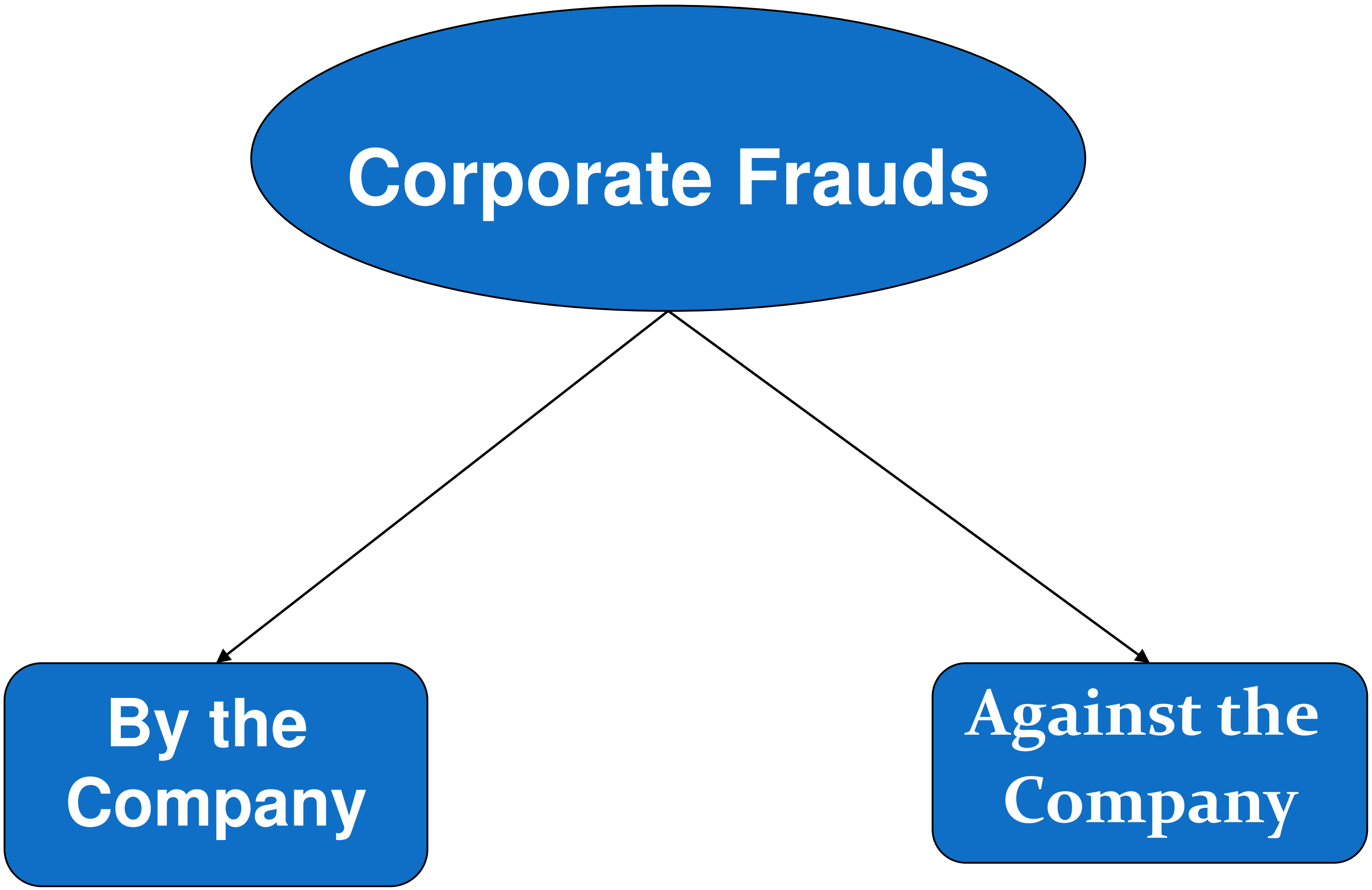
  Direct & Indirect taxes evasions, Sales Tax / VAT, Power theft, False claiming of exemptions, Money Laundering, etc.

Kinds of Frauds and Economic Offences

Kinds of Frauds & Scams

- Theft of Data and Intellectual Property
- Corporate Frauds
- Financial Institution Frauds
- Health Care/Insurance Frauds
- Identity Theft
- NBFC/Co-op Banks/Chit Funds
- Money Laundering
- Cyber Frauds (Financial)
- New Generation Economic Offences (E.g. Schemes like Offering Cheap Loans, MLM, Ponzi)
- Insider Trading
- Commercial Terrorism

Corporate Frauds - Classification



Corporate Frauds Classification

Financial 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?

- Insider dealing
- Related party transactions

- Accounts misstatement
- Securities fraud

- Intellectual property theft
- Employee bribery

- False advertising
- Short shipments
- Defective products
- Price fixing

- Tax evasion

- Theft
- False refunds
- Bad cheques
- Advanced fee

- Short shipment
- Double billing
- False invoices
- Employee bribery
- Kickbacks

- False loss claims

- Expense account padding
- Embezzlement
- Theft of cash and property
- Theft of IP

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

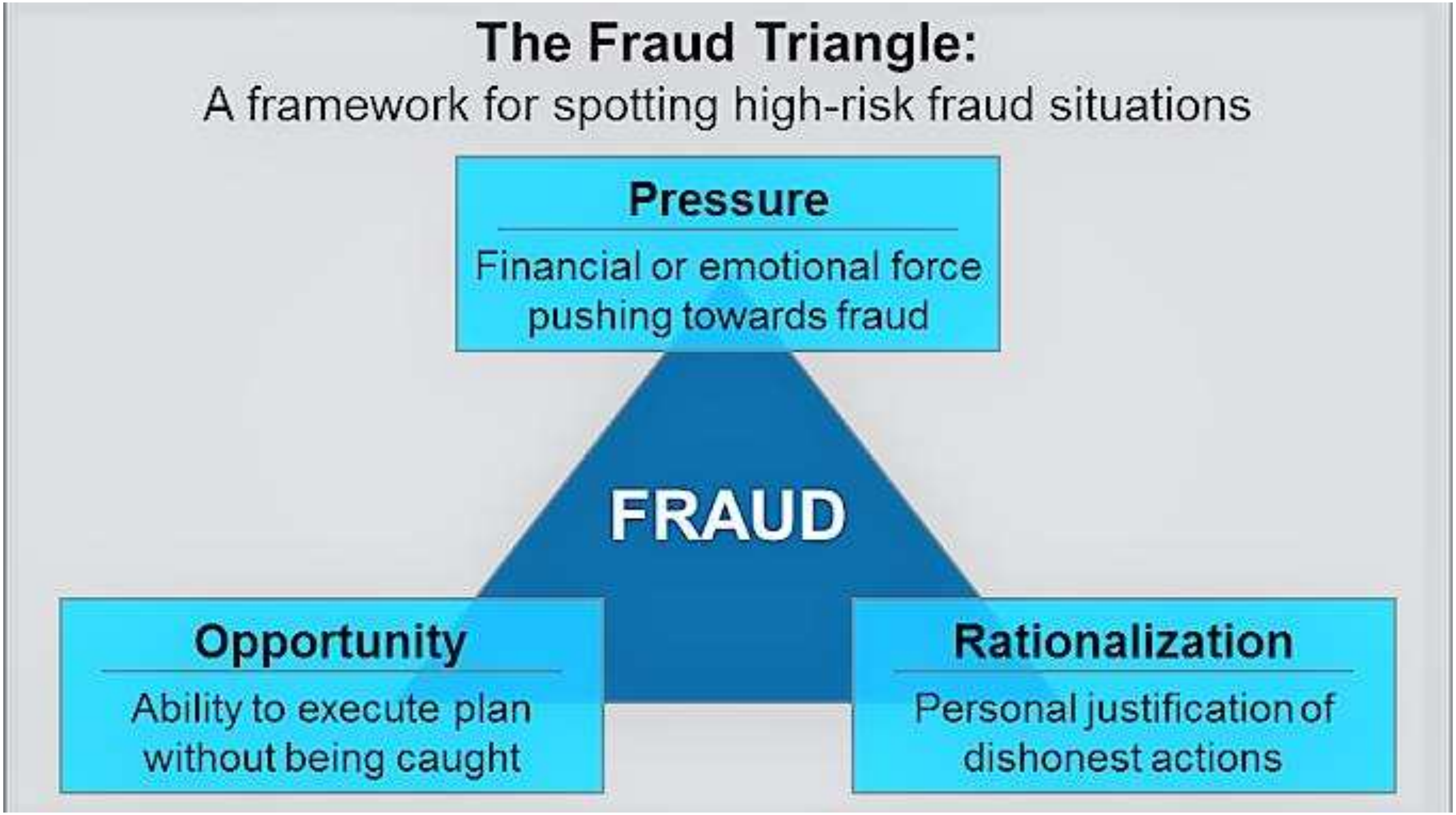
- Financial Statement Fraud
  - Revenue/Asset Overstatements
  - Revenue/Asset Understatements

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

- Corruption
  - Bribery
  - Illegal Gratuities
  - Conflict of Interest
  - Economic Extortion

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

Why GOOD PEOPLE do BAD THINGS



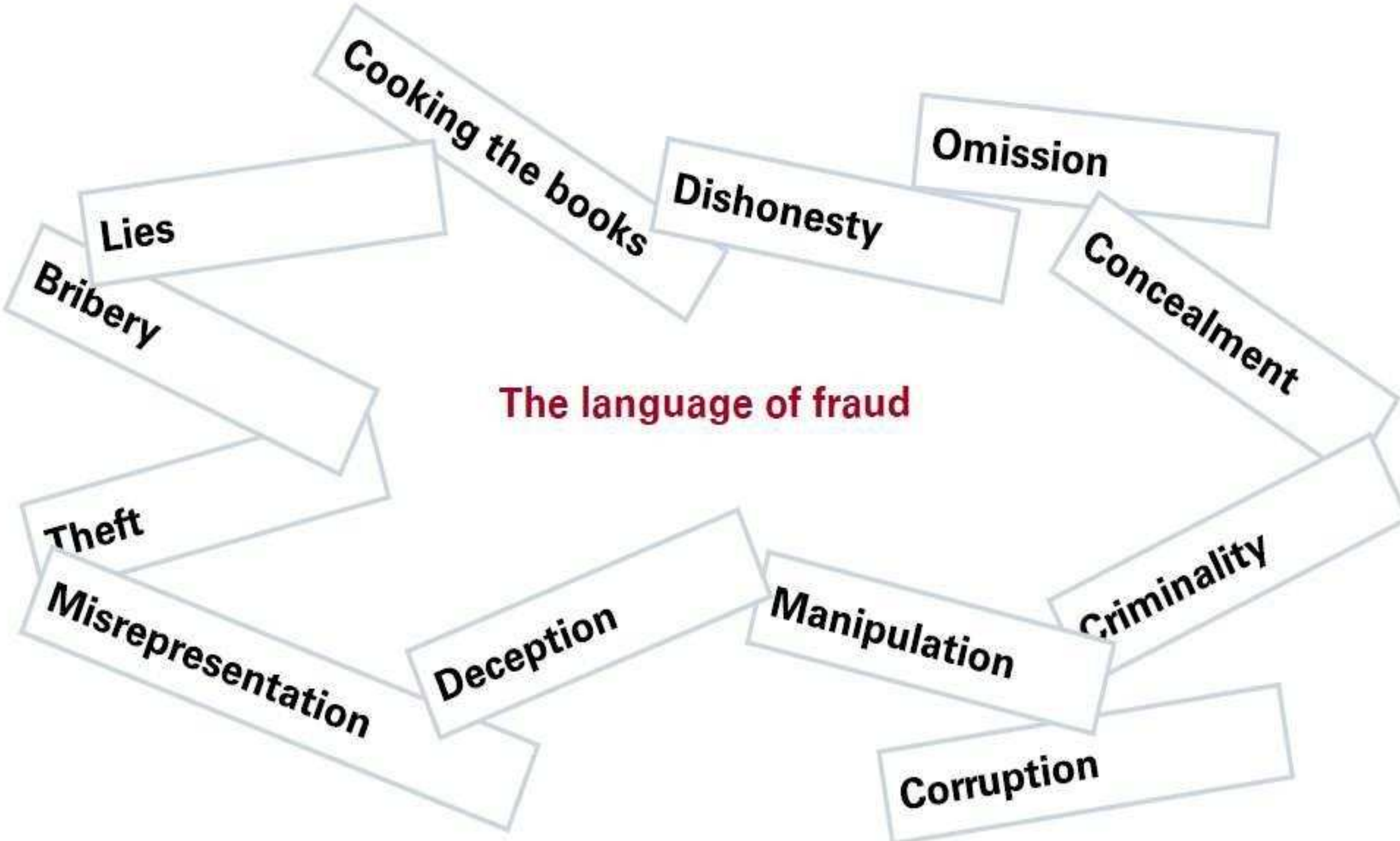
List of Large Scams in India

- Bellary Mines
- 2G Spectrum Scam
- Common Wealth Games Scam
- Uttar Pradesh NRHM Scam
- IPL Cricket Scam
- Madhu Koda Mining Scam
- Satyam Scandal
- Coalgate (Coal Scam)
- Vanishing Companies Scam
- Bank FDR's Scam
- Agri-Gold (AP, Telangana & other States)

- Antrix Devas Deal
- Chopper Deal Scam
- Tatra Scam
- Fodder Scam
- Ketan Parekh and the Stock Market
- Harshad Mehta
- Adarsh Housing Society
- Bofors Scam
- Hawala Scam
- Sharada Scam (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

Common Methods of Financial Statement Manipulations

- **Window Dressing**

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

- **Evergreening**

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

- **Recycling 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

Corporate Setup for Retail Frauds

- **Current rage among young educated criminals**
- 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 manipulate / 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

Company floated with a Nominal Amount & Minimum staff

Office & Residence Property taken on Lease

Show inflated No. of staff by creating bogus identities

Shows High Salaries paid, major portion of which is taken back

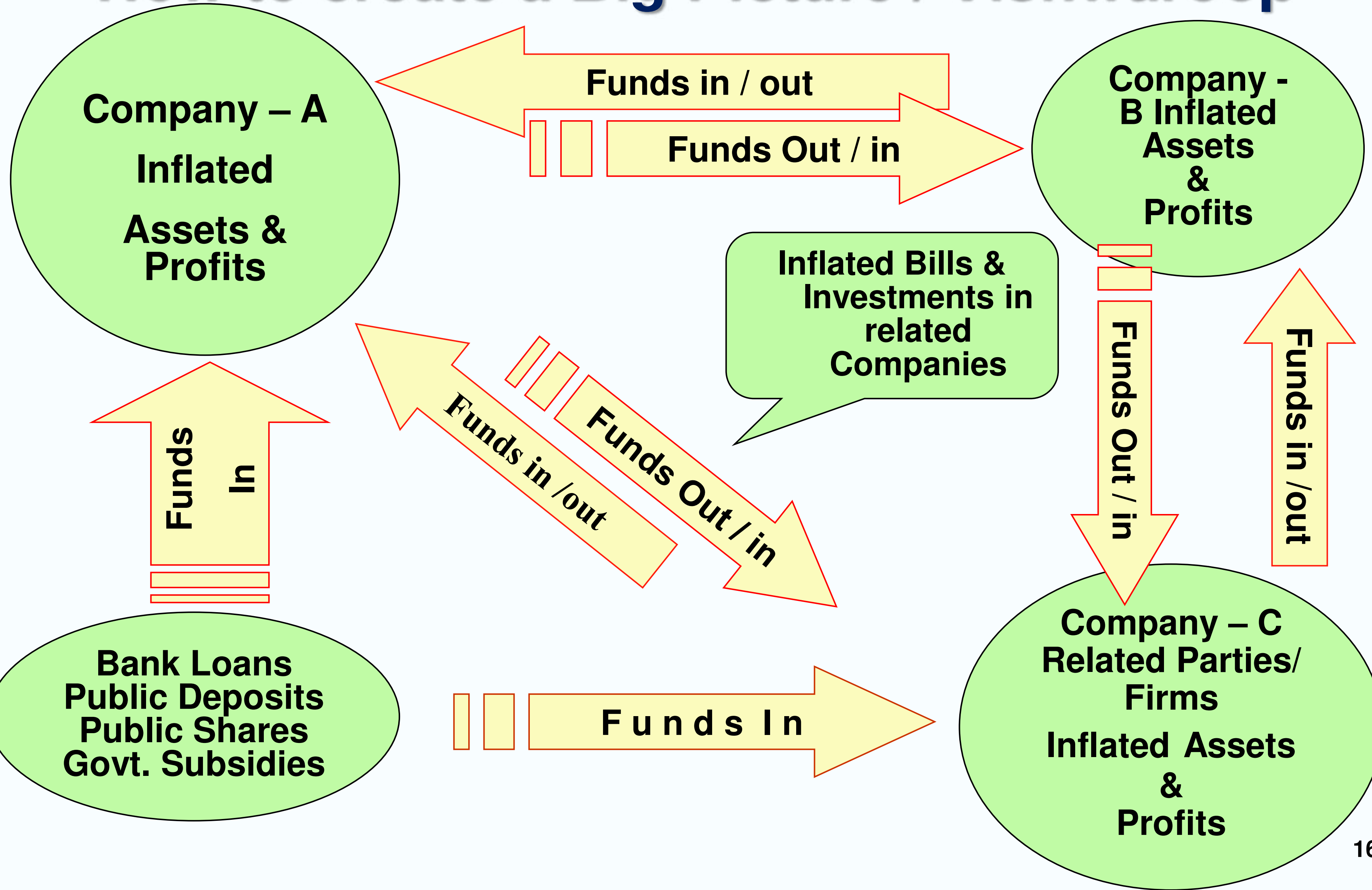
- Another company floated and inflated No. of staff is shown

Reclaimed salary is used to pay salary to staff of the new company

Approach multiple banks, avail loans/ credit cards and disappear to repeat same in another city

Corporate Frauds – Round Tripping / Recycling

How to create a Big Picture / Vishwaroop



Common Methods of Manipulations

- **Window Dressing**

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- **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

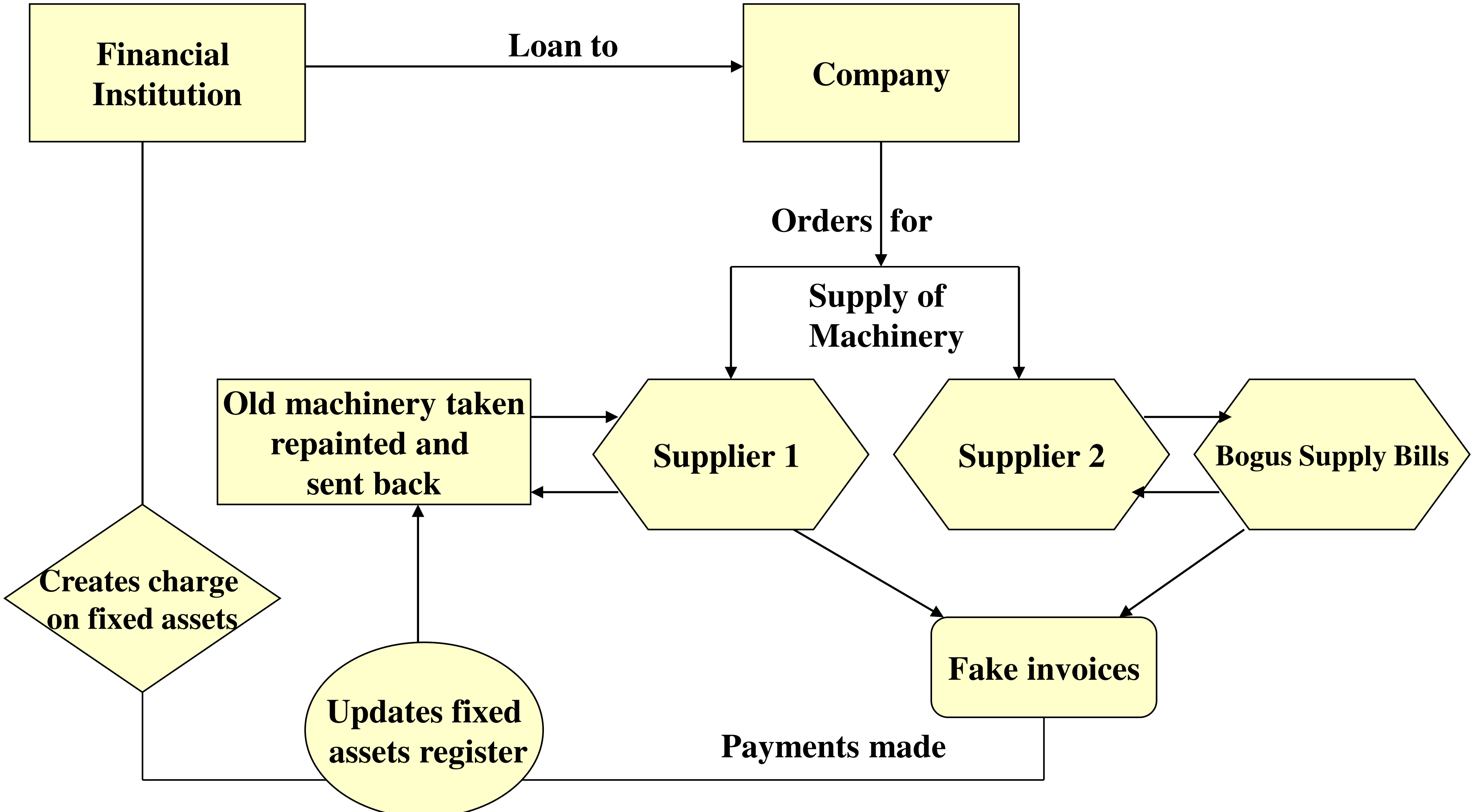
Impact on Financials

- *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 VAT input Show Promoters' Contribution	Booking Fictitious Expenses / Contracts, Ghost Employees/Staff, Consultancies, Huge Foreign Travel, VAT 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 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-Ex 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

<table>
<tr><th>Changes made</th><th>Impact</th></tr>
<tr><td rowspan="3"><u>LIABILITIES SIDE</u>

Actual Unsecured loan is Rs.40,00,000

Of this, Rs.30,00,000 is now ‘shown’ or ‘manipulated’ as Share Capital</td><td>Net Worth increased, better Debt Equity Ratio</td></tr>
<tr><td>Healthy improvement in Current Ratio</td></tr>
<tr><td>Good TOL/TNW Ratio</td></tr>
<tr><td></td><td></td></tr>
<tr><td rowspan="2"><u>ASSETS SIDE</u>

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</td><td>Significant improvement in Current Ratio</td></tr>
<tr><td>If Working Capital limits availed, better Inventory and Trade Receivables; Healthy numbers</td></tr>
</table>

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

will at some point of time,

MAKE <u>UP THE NUMBERS</u>

Any Questions / Clarifications?

Thank You

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