Interesting Case Studies on Financial Frauds

CA. Chandrasekhar. N FCA, ACCA, CFE, CAMS, CISA

CA & Fraud Examiner

ncsekhar.ca@gmail.com Mob: 9849130497

SATYAM COMPUTER SERVICES LIMITED

- Incorporated in 1987 by B. Ramalinga Raju as Chief Promoter
- Offers consulting and Information Technology (IT) services spanning various sectors, including
  - Engineering and product development
  - Supply Chain Management
  - Client relationship management
  - Business Process management
  - Business Intelligence
- Listed on
  - The New York Stock Exchange,
  - National Stock Exchange (India)
  - Bombay Stock Exchange (India)
- Presence spans over 60 countries.

KEY MILESTONES

1991	▪ Offshore software project with John Deere & Co.—first Fortune 500 customer—announced ▪ Debuts on the Bombay Stock Exchange
1993	▪ Awarded ISO 9001 Certification ▪ Joint venture with GE announced
1999	▪ Assessed at SEI CMM® Level 5
2001	▪ World's first ISO 9001:2000 company to be certified by BVQI ▪ Listed on the NYSE
2007	▪ Official IT Services Provider for the FIFA World Cups, 2010 (South Africa) and 2014 (Brazil)

Recipient of Several Awards

2009	Hyderabad Organizational unit assessed at a maturity level 5 on the SEI CMMI ver 1.2
2008	Best IT Practices in IT Sector
2007	Citizenship Partner of the Year Award, 2007 Second-Best Employer in India
2006	TDWD Best Practices Award Recognition Of Commitment (ROC) Award
2005	CMMI Level 5 Company-wide
2001-02	Security Standards Certification BS 7799
Pre 2001	SEI CMM® Level 5 Certification

And many more ……….

The Crisis … It all started like this

Dec 16: Satyam gets BODs approval for acquisition of Maytas Infrastructure and Maytas Properties for $1.6 billion.

Dec 17: Defers Maytas' acquisition on stiff investor resistance.

Dec 18: Schedules BODs meet for the proposal of buyback of shares on December 29.

Dec 24: World Bank bans Satyam for 8 years on charges of data-theft.

Dec 25: Satyam objects to World Bank's statements; asks Bank to apologize to the company or face legal action.

Dec 25: Mangalam Srinivasan, Non-Executive and Independent Director resigns from Board.

Dec 27: Postpones BODs meeting to January 10, 2009 to consider buyback of shares.

The Crisis ... It all started like this

Dec 27: Promoters disclose that their entire holding in Satyam pledged with Institutional Lenders since 2006.

Dec 28: Two Independent Directors - Krishna G. Palepu, Vinod K. Dham – resign from the Board.

Dec 29: M. Rammohan Rao, another Independent Director, resigns from Board.

Jan 02: Promoter holding in Satyam drops to 5.31 per cent from 8.27 per cent after sale of pledged shares by lenders.

Jan 06: IL & FS Trust Company sells 2.45 crore shares of Satyam pledged to Institutional Investors by the Promoters

Jan 06: Raju family holding in Satyam falls to 3.16 per cent after sale of pledged share by lenders

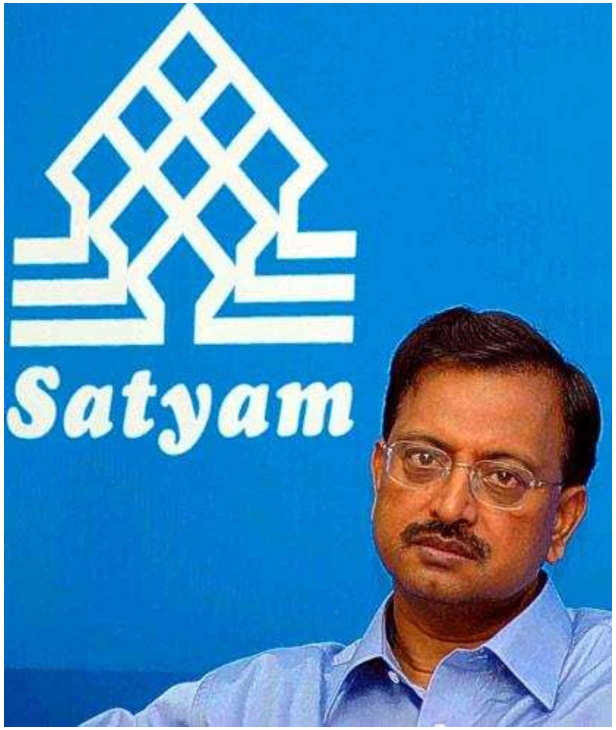
Jan 07: Satyam Chairman Ramalinga Raju, sends letter to BODs tendering his resignation and admitting to fraud in Accounting Books.

Satyam Managing Director B. Rama Raju also resigns. DSP Merrill Lynch terminated its advisory engagement with company.

Confession Letter from Mr. B. Ramalinga Raju

Four aspects of Accounting Frauds

- Non-existent cash and bank balances of Rs. 5,040 crore
- An accrued interest of Rs. 376 crore which is non-existent
- An understated liability of Rs. 1,230 crore on account of funds arranged by me
- An overstated debtors position of Rs. 490 crore (as against Rs. 2,651 reflected in the books).
- That in the last two years a net amount of Rs. 1,230 crore was arranged to Satyam (not reflected in the books of Satyam) to keep the operations going by resorting to pledging all the promoter shares and raising funds from known sources



Satyam Case Investigation

- The Investigation Methodology in this case has opened doors for unearthing many Corporate Scams in India and also resulted in coming up with changes in several Legislations.
- Several Agencies have carried out the Investigation of this Scam pursuant to their respective operative enactments – AP CID (subsequently CBI), SFIO, ED, SEBI, RoC etc., are few examples

Satyam Case - Gist of Fraud

- Fictitious Sales booked over a period of 6 years amounting to Rs.6500 crores (approx)
- Inflated Current Account balances to the extent of Rs.1700 crores
- Inflated Fixed Deposits with various Banks to the extent of Rs. 3300 crores
- Unaccounted loans to the extent of Rs.1230 crores not shown as is but declared as sales (shown through bogus sales realization)
- Non existent Interest income shown over a period of 6 yrs
- Bogus Credit for Income tax shown as paid abroad, which was not the case actually
- Inflated Turnover & Profits, resulting in
  - Higher EPS, Dividend, Book Value and higher share valuations
  - Promoters' realizing the benefits from the market through sale/borrowings from shares

Satyam Fraud Methodology

FRAUD AREA	METHODOLOGY
Fixed Deposits	FDRs as well as periodical confirmation letters were prepared within the Company, duly printing bank letter heads etc. Two sets of Fixed Deposit confirmation letters from same bank on same date were available in Auditors File, which was seized during searches. Inflated FDRs were worth Rs.3300 crores
Current Account	Manipulation was done in 1 single Current a/c, which is outside India. The close confidants of Management were entering the data sent by the main office on a monthly basis in the Oracle Financials system directly and sending to Finance Dept. which carried them to regular Books of Accounts and shown in the reported Financial Statements. The inflated Current Account Balance was Rs.1732 Crores.
Sales	Fictitious Sales & Receipts fabricated from clients (including reputed companies) to inflate the earnings to the extent of Rs. 6500 crores over a period of 6 years. Bogus entries were systematically made in the Financials & Bank Statements, showing Fictitious Invoices & receipts from Debtors towards non-existent sales, using a technique called Excel Porting, at penultimate level, bypassing the previous stages of entry controls. Totally, 7561 fake invoices were generated & 6603 invoices entered through Excel Porting.

Investigation regarding
Invoicing Part

- All the invoices were generated from the ADMIN login and the ADMIN login and passwords were shared by hundreds of people. There was no system of tracking the IP – addresses in the whole software process.
- Different software was used for the creation of the invoices. There were different levels of creation of the invoices at various levels.
- The logic behind using the six different software's was to strengthen the process of the invoicing and justifying the same with the efforts taken and that adequate approvals were provided.
- However these details were allowed to be manipulated at the final level of consolidation in to the oracle financial systems. Every single detail was amendable through the excel uploading / porting into the system of invoicing.
- In the final level of consolidation of the invoices, there was a program to 'hide' or 'show' the invoice from the billing or from the business finance functions so that there is no red flag raised by the Project Managers or other members in whose names the invoices were generated.

How Fraud was established in Invoicing Part ?

- Based on Data Mining & Analysis, it was identified that there is a flag ‘S’ ‘H’ for certain invoices. All the investigators presumed that **“S” indicates ‘Show’ & “H” indicated ‘Hide’**
- Query fired to retrieve that invoices with ‘H’ flag, but they turned out to be genuine. Invoices with ‘S’ flag turned out to be fake invoices. Thus, **they have ‘inter-changed’ the functionality of ‘H’ & ‘S’**
- Log of the records with ‘S’ Status was analyzed to check the employees indulged in booking these invoices
- Time sheets of those employees, hours of work logged were mapped to time they made bogus entries. Employees were identified and charged

Satyam Fraud Methodology

FRAUD AREA	METHODOLOGY
Unsecured Loans Pumped into Company	The promoter pumped in around Rs.1424 crores into the company through 37 entities, again using 327 front companies by borrowing & selling of his shares and out of this amount, Rs.194 crores was repaid thus leaving Rs.1230 crores outstanding All these were not recorded "as it is" (as loans) in the books of account but shown in different form (Sales & Debtors realization) in the fabricated current account bank statement given by the Chairman's Office. As entry for both is CREDIT only, this is a clear case of Financial Statement manipulation
TDS Receivable	Actual TDS Deducted by banks was Rs. 19 lakhs. However, as per Books it was shown as Rs. 67 crores No Reconciliation was ever done between Bank Balances, Interest earned, TDS effected, Annual Accounts, IT Returns & IT Assessment Orders
Other Areas	Debtors were overstated by Rs.500.20 Crores and Interest accrued was also overstated by Rs.376.10 Crores

Auditors’ Lapses Pointed Out

- In the investigation of Satyam Case, CBI had looked into various Audit evidences vis-à-vis the applicable Auditing Standards of ICAI and pointed out several gaps in its FIR (quoting Standard wise)
  - For example, it has pointed out that independent confirmations were not obtained and they relied on Data given to them by Auditee
- It indicates that somebody else is tracking or examining our Audit Work Quality/Documentation from their own investigative/usage perspective in future, for which Auditors might not have proper justification at that point of time

Audit Methodology Differences

- In this case, CBI also compared the Audit Evidence Collection Methodology by the same Auditor, for a different company, in the same industry and of same size and came out with **glaring differences**
- They found that same Auditors, in an effort to ascertain the authenticity of Sales Invoices raised by client, collected live invoice samples from relevant Computer System in the other company but did not perform the same in Satyam case where they preferred to rely upon hard copies supplied by key accused which ultimately proved to be fake
- For the other company, they obtained direct confirmation on requisite proforma from Bankers and also reviewed Current Account balances online; however in Satyam Case, they relied on Forged Bank Confirmation Letters supplied by accused while conducting Audit and also failed to verify balances online
- For the some other company, Auditors directly wrote to Debtors and Vendors but failed to adopt similar Audit Protocols while auditing Satyam

System Audit Findings

- IS Audit was also conducted which pointed out "Several IT System Control deficiencies" but Auditors had ignored them

- According to CBI findings, the Systems Process Audit Team had cautioned that ***"these deficiencies are significant in nature which can affect the genuineness of the financial statements of the company and hence reliance cannot be placed on the IT System Controls."***

- CBI, in its report had accused the Auditors of taking part in the conspiracy by failing to inform the Satyam Audit Committee about the system control deficiencies that were *"significant in nature"*. ***Instead, the Auditors had wrongfully presented to the Audit Committee that "the system control deficiencies are NOT significant".***

PONZI SCHEMES

- Fraudulent investment schemes where returns are paid to existing investors from the capital contributed by new investors, rather than from profits.
- Ponzi scheme is named after swindler in 1920s Mr. Charles Ponzi, who was notorious for using this scheme
- It is an illegal business practice where new Investor's money is being used to make payments to earlier Investor
- In pure accounting term, this could be stated as the income paid to investors, is actually Distribution of Capital
- It is not '**Return** **ON** **Capital**' but a case of '**Return** **OF** **Capital**' – Ex. Saradha Chit Fund Case

PONZI SCHEMES

KEY FEATURES

- Above Market or Extraordinarily High ‘Guaranteed’ Returns to prospective investors
- Visible Legitimacy or showing High Reputation
- Attractive Commissions for Sales / Marketing team
- Exploiting Investor ‘Greed’ is the key and whomsoever does it effectively, they will be ‘successful’
- Many a time, involves ‘unregistered Investment’ products, which they sell
- Marketing & Exclusivity of Dealerships

Ponzi Scheme of Frauds

Saradha Chit (Cheat?) Funds Case

- Collected Rs. 2500 crores from 14 Lakh investors
- Classic case of Ponzi Scheme of Fraud where 30% to 40% of collections will be paid as brokerage & commissions
- One person's interest paid from proceeds of collection from another investor and this chain goes on
- Scheme collapses when there are no new investors
- Hence huge number of agents are appointed with very lucrative commission
- Will collapse when investors demand their moneys be paid back suddenly in one go
- Gap in monitoring by various laws – State monitors Chit funds, SEBI oversees collective investment schemes & RBI regulates NBFCs

SARADHA CHIT FUNDS CASE (Contd..)

KEY ANALYSIS OF FACTS UNDERLYING CASE

- Like any successful Ponzi Scheme, in Saradha also, the rate of return promised was high and was fixed at the time the investor entered the scheme
- Saradha had instalment plans from 12 to 60 months, were minimum instalment was as low as Rs.100 per month.
- At the end of tenure, investor had option to either get allotment of land or flat or simply get refund of money paid with interest ranging from 12% to 24% p.a
- Clearly, the rates being offered are substantially higher than return through other investment schemes
- Saradha employed agents of Peerless General Finance, which was very prominent one in Eastern India since 1932, which carried good reputation
- Total field Agents were around 2.5 lakh in number

SARADHA CHIT FUNDS CASE (Contd..)

KEY ANALYSIS OF FACTS UNDERLYING CASE

- Another vital part for a successful Ponzi Scheme is that the entity appears to be a genuine investment opportunity and Brand Building
- Here, Saradha succeeded by projecting itself that they are into multiple line of business from real estate to two wheelers to media to tours and travels and even bio gas.
- Company even bought a 2 wheeler company which was closed in 2011 to show off to Agents as if it is running and they even retained around 150 employees on rolls and showed that operations were in full swing when certain Agents made visits to Factory, to create an illusion that the moneys being invested were put to productive use
- Company also expanded hugely into Media through Channels and Daily Newspapers, roping in top celebrities and hence maintaining the Branding. Even one of the MP was CEO of Group’s Media Business and there was nothing to stop them at that time

Any Questions / Clarifications?

Thank You

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ncsekhar.ca@gmail.com Mob: 9849130497