

Topic: Banking Regulation Act and Forensic Audits

1. Banking Regulation Act:

1.1 Meaning-

Indian Banking Regulation Act was passed in the year 1949 and further amended in the year 2017. The act is applicable to the whole of India. The provisions of this act is applicable in addition to the other acts, as applicable, like Companies Act, 2013, etc. i.e. this act is not an exemption or relaxation of a rule or law.

Banking refers to the accepting deposits of money from the public, repayable on demand or otherwise, for the purpose of lending or investment, or withdrawal by cheque, draft, and order or otherwise.

1.2 Analysis of the key sections -

- a. **Section 10** - Prohibition of employment of Managing Agents and restrictions on certain forms of employment, no banking company shall be managed by any person for more than 3 months if the person is a director of any other company. However Section 10B, clearly depicts that banking company to be managed by Whole Time Chairman.

Analysis - This sub section was exquisitely construed by Mr. Waryam Singh in the case of HDIL v/s PMC bank (NBFC). Since, section 10A speaks about managing the affairs of banking company (i.e. Managing Director), Mr. Waryam Singh engaged himself with the bank in the capacity of Chairman.

(Source: Financial statement available on website of PMC bank)

But while further reading the act, Section 10B, states that Chairman shall exercise his powers subject to the superintendence, control and direction of the Board of Directors.

Since Section 10 overrides all the laws, contracts, etc. any such person shall not be entitled to claim any compensation for the loss or termination of office, notwithstanding anything contained in any law or in any contract, memorandum or articles of association.]

- b. **Section 20** – No banking company can grant loans or advances to any company in which director of the banking company is a Director, Managing agent, manager, employee or guarantor or in which he holds substantial interest.

Also RBI vide circular no. 10/13.03.00/2015-16 dated 15th July, 2015, Banks are prohibited from entering into any commitment for granting any loans or advances to or on behalf of any of its directors, or any firm in which any of its directors is interested as partner, manager, employee or guarantor, or any company [not being a subsidiary of the banking company or a company registered under Section 8 of the Companies Act, 2013, or a Government company] of which, or the subsidiary or the holding company of which any of the directors of the bank is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest, or any individual in respect of whom any of its directors is a partner or guarantor.

Analysis – *As per the news on preliminary forensic audit report of PMC bank, majority of the funding of PMC bank was to HDIL group, in which one of the director Mr. Waryam Singh, who also the Chairman of PMC bank. The same results into contravention of the Indian Banking Regulation Act as the bank cannot lend the money to the companies in which the KMP's are interested.*

Before starting of any forensic audit, forensic auditor should diligently identify the relation between the promoters and KMPs with the lenders of the enterprise. If any kick-backs have been provided to the bank's personnel, the same should be covered as a part of the forensic audit report as it is the fiduciary duty of the forensic auditor to up bring all the relevant facts with the consortium members, whether the same cause harm to the consortium members or not.

1.3 Analysis of Clause 16 of Companies (Auditor's Report) Order, 2016:

- a.** Clause 16 of the CARO deals with whether the company is required to be registered under Section 45 IA of Reserve Bank of India Act, 1934.
- b.** According to the RBI press release 1998-99/1269 dated 08.04.1999, a company will be treated as NBFC if its financial assets are more than 50% of its total assets (netted off by intangible assets) and income from financial assets should be more than 50% of its gross income.
- c.** During the forensic audit, in many cases it was identified that the parent company forms some investment company as a subsidiary for routing the money out of the system in the form of loans. Forensic Auditor should check the applicability of Clause 16 of CARO, 2016 and if the condition violates, it will result into violation of Reserve Bank of India Act, 1934.

2. Forensic Audits

2.1 Meaning of Forensic Audit:

The Oxford dictionary defines forensic as (adjective) relating to or denoting the application of scientific methods and techniques to the investigation of crime, and (noun) scientific tests or techniques used in connection with the detection of crime

The dictionary defines forensic accounting as (noun) the use of accounting skills to investigate fraud or embezzlement and to analyse financial information for use in legal proceedings.

Forensic Audit means the examination and evaluation of an entity's financial information to arrive at the true picture of the various business activities. Forensic Audit does not stop with mere audit of accounts, but it goes a step further and find out the basis on which each transaction has taken place and basis on which the decision was taken by the entity.

The Forensic Audit also finds reference in the notification issued by the Reserve Bank of India, in RBI/2015-16/75 DBS.CO.CFMC.BC.No.1/23.04.001/2015-16 dated July 01, 2015, i.e. fraud committed by unscrupulous borrowers.

2.2 Who can conduct forensic audit?

Appointment of forensic auditor depends on the agencies that are willing to conduct forensic audit of books of accounts of the company. For example, if financial institutions want to conduct the forensic audit, they have to appoint the forensic auditor from the list of empanelled firm registered with Indian Banking Association. SEBI, SFIO, etc. have their own registered empaneled forensic audit firms.

2.3 Scope deficiency and limitations in Forensic Audit:

- a. The scope of forensic audit in most of the case limits to the last 2 to 4 years from the date of NPA. Experienced forensic auditors are aware that majority of the big industrialist starts the preparation of fraud and manipulates the books of accounts much earlier.
- b. The scope of the forensic is limited only to the firms/ companies where the fraudulent transactions are suspected. It should ideally cover all the group/ related companies and persons identified during the course of the assignment.
- c. The forensic auditor cannot compel anybody to produce information, conduct searches, and acquire records and accounts of group / related companies.
- d. Limitation of data from the financial institutions. In many cases, it was observed that due to lacuna of documentation and negligence by the bank staff, banks are reluctant in providing the data to the forensic auditor.
- e. No access to electronic information with borrowers. The forensic auditor by law cannot access the servers, laptops and electronic records of the borrower due to which the auditor cannot find evidence related to diversion and siphoning of funds.

2.4 Timelines for completion of forensic audit:

As per RBI circular, the forensic audit must be completed within a maximum period of three months from the date of the JLF meeting authorising the audit. Within 15 days of the completion of the forensic audit, the JLF will reconvene and decide on the status of the account, either by consensus or the majority rule as specified above.

In case the decision is to classify the account as a fraud, the RFA status would change to Fraud in all banks and reported to RBI and on the CRILC platform within a week of the said decision. Besides, within 15 days of the RBI reporting, the bank commissioning/ initiating the forensic audit would lodge a complaint with the CBI on behalf of all banks in the consortium/ multiple lenders banking.

2.5 Case laws useful in forensic audit:

a. **Integrated Equipment & Infra Services Pvt. Ltd. (IEISPL) v/s Dena Bank, Calcutta High Court**

Case: IEISPL has availed borrowings from the consortium members. After default of few instalments, consortium appointed two forensic auditors. Both the auditor reported no diversion and siphoning of funds. Dena Bank wants to appoint the third forensic auditor, for which no other member in the consortium agreed. Dena bank argued that since in the agreement itself that member bank could take decision severally, and hence individual bank can proceed with the issue of notice.

Judgement: The Calcutta High Court pronounced that Court could not by its order directly or indirectly restrains the bank from filing a legal proceeding. However, since the company is willing to pay the instalments as per schedule, the Dena bank should not move the application until the expiry of the timelines for repayment of debt.

Similar Identified case: In one of media client, we have noticed that a PSU bank wants to appoint an independent forensic auditor. However, as the majority of the banks are not passing the resolution in favour of appointing, no forensic auditor has been appointed yet.

b. **Atlantic Projects Limited v/s Allahabad Bank & Others, Calcutta High Court**

Case: Bank has issued letter of wilful default against the company placing reliance upon a forensic audit report. Company has not responded to the letter of wilful default, as no copy of the said forensic audit report was supplied in spite of several representations submitted to that effect.

Judgement: The Calcutta High Court pronounced that the copy of forensic audit report should be handed over to the borrower and 2 weeks of time should be given to reply to the letter.

Conclusion: While doing the forensic audit, forensic auditor must ask bank to share the forensic audit report with the client for seeking their reply. Otherwise, the report can be challenged in the court by virtue of the fact that the client had not given reasonable opportunity to present their replies on the report.

2.6 Considerations of other laws and regulations to be taken care while doing forensic audit :

Forensic auditor can go beyond the documents to identifying whether the transaction has been entered with bona-fide or mala-fide intention. The auditor during the course of assignment should check the available documents, trail of funds, intention and red flag present at the time of entering into the transactions, beneficiary from the transactions, etc. along with the powers of the board of directors governed by Memorandum of Association, Articles of Association and Rules of Procedure.

However, forensic auditor must also take care of other laws and regulations in the audit report like:

- a. **Indian Advocates Act** – Supreme Court of India in the case of Bar Council of India v/s A.K. Balaji and Others pronounced that providing legal opinion and validity of any documents also amounts to providing legal opinion. As per Advocates Act, 1961, no person other than practising legal advocate can provide legal opinion. While performing the forensic audit, forensic auditor can quote this case law and restrict ourselves to opine on the legality of transaction.
- b. **Evidence Act, 1872** – Under Section 3 of the Evidence Act, all documents including electronic records produced for the inspection of the Court together constitutes to be documentary evidence. So while forming an opinion on the basis of documents, forensic auditor should check the authenticity and reliability of the documents.
- c. **Information and Technology Act, 2000** - Section 73 and 74 of IT Act, 2000, lays down penalty for unauthorized copying of an extract from any data, Unauthorized access and downloading files and Providing assistance to any person to facilitate unauthorized access to a computer. During the course of audit, forensic auditor should not access the client data and files before written authorization from the client.
- d. **International Laws** – The forensic auditor should safeguard himself for violating the foreign laws like Foreign Corrupt Practices Act 1977, United Nations Convention against Corruption, multilateral treaty or agreement between India and other countries, etc. For this, disclaimer can be made in the start of the report that this report can be used only in India and should be interpreted in accordance with the applicable Indian Laws only.

3. Important circulars and case laws relating to forensic audit:

3.1 Circular:

As per the RBI circular DBR.BP.BC.No.41/21.04.048/2015-16 dated 24th September, 2015 for “**Prudential Norms on Change in Ownership of Borrowing Entities (Outside Strategic Debt Restructuring Scheme)**”, financial institution can upgrade the asset classification in their books if

- a. The ‘new promoter’ should not be a person/entity/subsidiary/associate etc. (domestic as well as overseas), from/belonging to the existing promoter/promoter group. Banks should clearly establish that the acquirer does not belong to the existing promoter group; and
- b. The new promoter should have acquired at least 51 per cent of the paid up equity capital of the borrower company. If the new promoter is a non-resident, and in sectors where the ceiling on foreign investment is less than 51 per cent, the new promoter should own at least 26 per cent of the paid up equity capital or up to applicable foreign investment limit, whichever is higher, provided banks are satisfied that with this equity stake the new non-resident promoter controls the management of the company.

Analysis:

Circular allows the financial institutions to restructure/ upgrade the borrower account from NPA to standard on the account of change in majority of the shareholding and promoter of the borrower. However, the section states no minimum time limit or lock in period for the new promoters to hold the shares.

Similar Identified Case:

In one of the forensic audit, forensic auditor had identified that company engaged in manufacturing of cement and clinker took the benefit of this circular and sold majority of the shares to a company in India controlled by a renowned group of Dubai. Within 6 months of the aforesaid transaction, company’s erstwhile promoters again buy back majority of the stocks sold to Indian company.

During detailed analysis, it was found that Indian company has taken short term advances from 2 Indian companies namely A & B of approx. Rs. 335 Crores. Indian company has purchased the majority of the stock in the cement company (borrower). The borrower in return has issued order for capital work to two parties i.e. C & D. A, B, C & D are linked to each other’s by having common directors and same addresses. Later on, the advances given for capital advances have been written off from the books of account of the cement company.

The basic motive behind this circular was defeated by such impugned scheme of restructuring. The forensic auditor should carefully examine the change in shareholding pattern as it will give the rationale behind entering into such transactions.

RBI may amend the circular from the perspective of imposing some minimum time limit or lock in period for restricting the new promoter to sale the shares.

3.2 Kingfisher Air Lines (KAL) & Others V/s Union of India & Others, Calcutta High Court

Outline of case:

KAL has been declared as wilful defaulter by Grievance Redressal Committee of United Bank of India on 1st September, 2014.

KAL filed write petitions against the decision of United Bank before Calcutta High Court for following issues:

- a. The Master Circular on Wilful Defaulters issued by the Reserve Bank of India is not a piece of subordinate legislation and, therefore, it is not binding on a bank carrying on banking business in India. He submits that, the Master Circular does not have statutory force.
- b. Master Circular requires two committees to be formed by a bank i.e. Identification Committee and Review Committee for identifying a borrower as wilful defaulter.
- c. Grievance Redressal Committee have not provided us the documents on the basis of which wilful defaulter notice has been issued against the writ petitioners.

Ruling of Court:

- a. the Master Circular being issued under Section 35 A of the Banking Regulation Act, 1949 is binding on a bank and a financial institution carrying on business in India.
- b. The purpose specified is to put in place a system to disseminate credit information pertaining to wilful defaulters for cautioning banks and financial institutions so as to ensure that further banking finance is not made available to wilful defaulters. The Master Circular defines the term "wilful default". The terms "diversion of funds" and "siphoning of funds" are also defined by the Master Circular. The Master Circular contemplates that once a constituent is identified as a wilful defaulter, such constituent will be prevented from accessing to the capital markets by forwarding the list of such wilful defaulter to Securities and Exchange Board of India by the Reserve Bank of India and to Credit information Bureau (India) Limited. The Master Circular requires a bank and a financial institution to take measures in identifying and reporting instances of wilful default.
- c. The other guidelines like forming a committee specified in the master circular are not directory but mandatory.

Important point: Non-providing of documents on the basis of which application of wilful default was filed cannot be construed to be a breach of any principle of natural justice. Master Circular does not require the documents to be made over to the writ petitioners prior to the hearing before the Grievance Redressal Committee, making over such documents in course of the hearing before the Grievance Redressal Committee as and when the same were sought to be relied upon before the Grievance Redressal Committee would have been sufficient compliance of the principle of natural justice.

4. Tools that can be used in Forensic audit:

4.1 USB Devview – It is small utility software that lists all USB devices that are attached to the system till date. It also shows devices that are presently connected with the system. In simple words, through this application, during the forensic audit, you can identify how many pen drives, hard disks, etc. were used to transmit the data out of the system.

Forensic auditor should always use V Vault pendrive which has an in-build special feature that no log can be recorded.

4.2 Dump It – It helps you to copy all the data stored in the Random access memory of the pen drive or hard disk within few minutes. If the client or any agency authorizes you to access and decrypt the data from the external hard disk, you can use this software to extract the data from the RAM.

4.3 Event Log Explorer – This application is used in checking the internet logs. The fraudster might have search the way to fraud or consequences of the fraud on the internet. By running this application, you can get all the details of surfing.

Forensic audits are not only the remedial audit, it can be preventive too. By knowing the intention of fraudster at early stage, you can raise the issue with the higher management or appropriate authority, as the case may be.

4.4 Stenography – During the course of forensic audit or at the time of finalisation, at many times forensic auditor needs to share the draft report online to other partners/ managers for the purpose of review. Auditor decrypts the file by using the password. Now the question arises, password shared on Whatsapp or over the call is safe? **Stenography allows you to hide your password behind any image.** The recipient can only access to the password if he use the same software in his device.

Also while auditing, if auditor find any irrelevant images shared on mail between the persons of the enterprise, auditor should use Stenography tool to check the secret message hiding behind the image.

4.5 Others – There are many other software's that can be used by the forensic auditor in identify the misstatement like ActiveWhois, Autopsy, eMailTrackerPro, HashMyFiles, Recover My Files, etc.

Note: The use of IT enabled tools for data access and retrieval should be used only after the proper authorization from the client in written or order from court or any statutory authority.

5. **Few common areas used by the fraudster for diversion and siphoning of funds:**

- a. **Huge Capital advance** – PO and Invoice does not suffice the fact that the transaction was entered into the normal course of business. Forensic auditor needs to determine the relevance of the particular expenditure at that particular point of time. Huge capital advance might be used by the fraudster to park the money in some other entity and later on providing off the advances in the books of account by taking the benefit of lacuna in the agreement through arbitration.
- b. **Fixed Assets** – In many of the cases, forensic auditor has noticed that the term loan disbursed was transferred to some group entities on account of purchase of fixed assets. However, no actual supplies of the fixed assets were made. Forensic auditor should map all the disbursement of term loan with the fixed assets register.
- c. **Intangible assets** – IA comprises mainly of goodwill. In many cases, goodwill is generated due to amalgamation or merger. The value paid by the acquirer compared with the fair values of the identifiable assets and liabilities acquired, and the difference (goodwill) is recognised as an asset. Forensic auditor should check the scheme of amalgamation/ merger to identify the realisable value of goodwill. In the case of trademarks, copyrights, etc. the same should be verified from the trademark registry website about the owner of the trademark.
- d. **Investment, Loans and advances** – Deploying the funds in subsidiary and step down subsidiary was covered under the definition of diversion of funds as per the circular issued by RBI dated July 1, 2015 on wilful defaulter i.e. “transferring borrowed funds to the subsidiaries / Group companies or other corporates by whatever modalities”.

In many cases, forensic auditor has noted that parent company uses the borrowing from the financial institutions for granting loans/ advances to subsidiary or group entities. After 2-3 years, on the ground of erosion of net worth and taking the benefit of Ind AS 10, revaluation of the value of financial instruments on the balance sheet date, writes off or provided for the value of loans/ advances/ investment through the P&L account or via other comprehensive income.

- e. **Trade Receivable** – Trade Receivable, a major item for calculating drawing power in case of short term facility (Cash credit) availed from the financial institutions, many borrowers use fictitious sales and debtors to avail the extra drawing power. Forensic auditors noted that the debtors reflected in the drawing power statement based on the threshold time period mentioned in the sanction letter (ex. 90 days) are more than the sales made during that particular time.

Forensic auditor also observed that in many cases that the parties attached with the stock statement for availing drawing power are not even found in the list of customers of the company. Before classifying the account under Section 66 of IBC, 2016 or as per RBI master circular on fraud by virtue of the above fact, forensic

auditor should also independently calculate the drawing power and comparison needs to be made between the actual available drawing power vis-a-vis drawing power as per the stock statement, because there might be a case where some debtors are eligible for calculation of drawing power but not disclosed by the borrower in the stock statement. If the borrower avails extra drawing power on the day of submitting the stock statement, then only the borrower can be classified as fraud, otherwise to prove the wrong intent of the borrower would be difficult.

Also forensic auditor should examine the fact that any enhancement of the existing credit facilities was sanctioned by the financial institutions on the basis of fraudulent stock statement, and then the auditor may classify the account as fraud.

- f. Inventory** – It is another major line item eligible for availing drawing power. Forensic auditor should diligently check the value of inventory shown in the annual financial statements and drawing power submitted to the bank. Variation in the value of inventory on account of obsolescence and degradation of quality cannot be more than +/- 5%.

Further, it was noted that quantity of stock disclosed in the DP statement is in many cases are more than the available capacity of storage in the warehouse or factory.

Many times, fraudster siphoned off the stock by showing increase in the burning loss in the manufacturing process and sold the balance stock in cash (out of the books). Forensic auditor should compare the chart of normal and abnormal loss for the last 5 years to know the average loss.

6. What is intent? Definition of intent as per Criminal Law? How you prove intent?

Intent is a mental attitude with which an individual acts, and therefore it cannot ordinarily be directly proved but must be inferred from surrounding facts and circumstances. Intent refers only to the state of mind with which the act is done or omitted.

In Criminal Law the concept of criminal intent has been called mens rea, which refers to a criminal or wrongful purpose. If a person innocently causes harm, then she or he lacks mens rea and, under this concept, should not be criminally prosecuted.

To prove anything, first of all the mala fide intention of the fraudster needs to be proved.

Section 66 of Insolvency and Bankruptcy Code, 2016, the transaction can be termed as fraudulent only if business of the corporate debtor has been carried on with **intent** to defraud creditors of the corporate debtor or for any fraudulent purpose.

Under Companies Act, 2013, to prove any wrong doing, the primary condition is intent behind entering into such transaction. Therefore, proving intention is necessary to prove the fraud.

Few points to be noted while proving intent:

- a. Repeatedly engaged in activity of an apparent wrongful nature.
- b. Conceal, destroy evidence or altering documents.
- c. Conflicting statements.
- d. False statements.
- e. Gained from the fraudulent act.
- f. Acted to hinder the investigation process.
- g. The suspect could not have a legitimate motive for his or her own actions.

7. Section 477A of India Penal Code, 1860 – Falsification of accounts

In the forensic audit, forensic auditor usually uses the word falsification or misrepresentation of accounts without knowing the end impact of that phrase. Forensic auditor should diligently draft the report.

Falsification of account means:

- a. Destroy, alter, mutilates or falsifying any books, paper, writing, valuable security or account, *(knocking off the balances of debtors and creditors)*
- b. Making of any false entry, *(passing any entry in the accounting system without proper documents)*
- c. omits or alters or abets the omission or alteration of any material particular **(disclosure of contingent liability, audit report to be qualified in respect of particular matter, etc.)**

Explanation.-It shall be sufficient in any charge under this section to allege a general intent to defraud without naming any particular person intended to be defrauded or specifying any particular sum of money intended to be the subject of the fraud, or any particular day on which the offence was committed.

Fine or Penalty – 7 years of imprisonment or fine or both to every clerk, officer, servant employed or person acting in any capacity with an **intention** to defraud.

-by CA Chintan Jain