

NEERAJ BHAGAT & CO.  
— Chartered Accountants —

A close-up photograph of a person's hands writing on a document with a pencil. The document features a pie chart and a bar chart. In the foreground, a calculator is visible. An orange notebook with a brown strap is also present. The background shows another person's hands typing on a laptop. A blue diagonal overlay is positioned in the bottom-left corner.

**Internal  
Controls**

# Content

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  - Ricoh India
  - Punjab National Bank

# What is Internal Control?



# Benefits of having a good system of internal controls

- Helping protect assets and reduce the possibility of fraud
- Improving efficiency in operations
- Increasing financial reliability and integrity
- Ensuring compliance with laws and statutory regulations
- Establishing monitoring procedures



# Benefits of internal audit

- The scope is **defined** by management or the Board (not an outside agency or adversarial entity)
- Internal Auditor “**reports**” directly to management or the Board
- Improves the “**control environment**” of the organization
- Makes the organization **process-dependent** instead of person-dependent
- Identifies **redundancies** and provides recommendations
- **Early Warning System**, enabling deficiencies to be identified and remediated on a timely basis
- Increases **accountability** within the organization.

# Indian Context

Internal Control for Financial Reporting (ICFR) in US



Internal Financial Control (IFC) in Companies Act, 2013

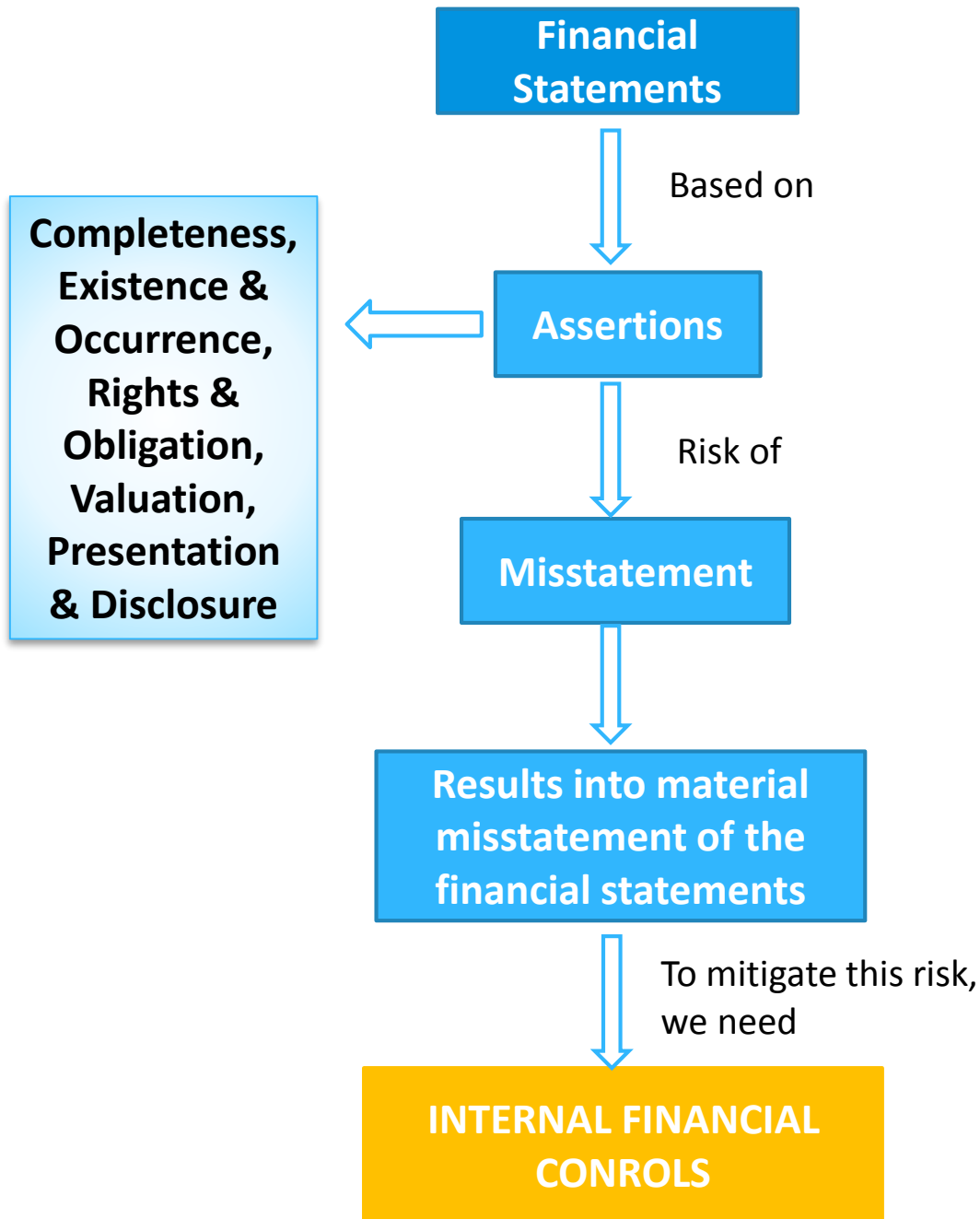


Adequacy and Operational efficiency of IFC

Sec 134(5)(e)  
Affirmation in  
Directors'  
Responsibility  
Statement

Sec 143  
Report in Auditors'  
Report

# Why IFC?



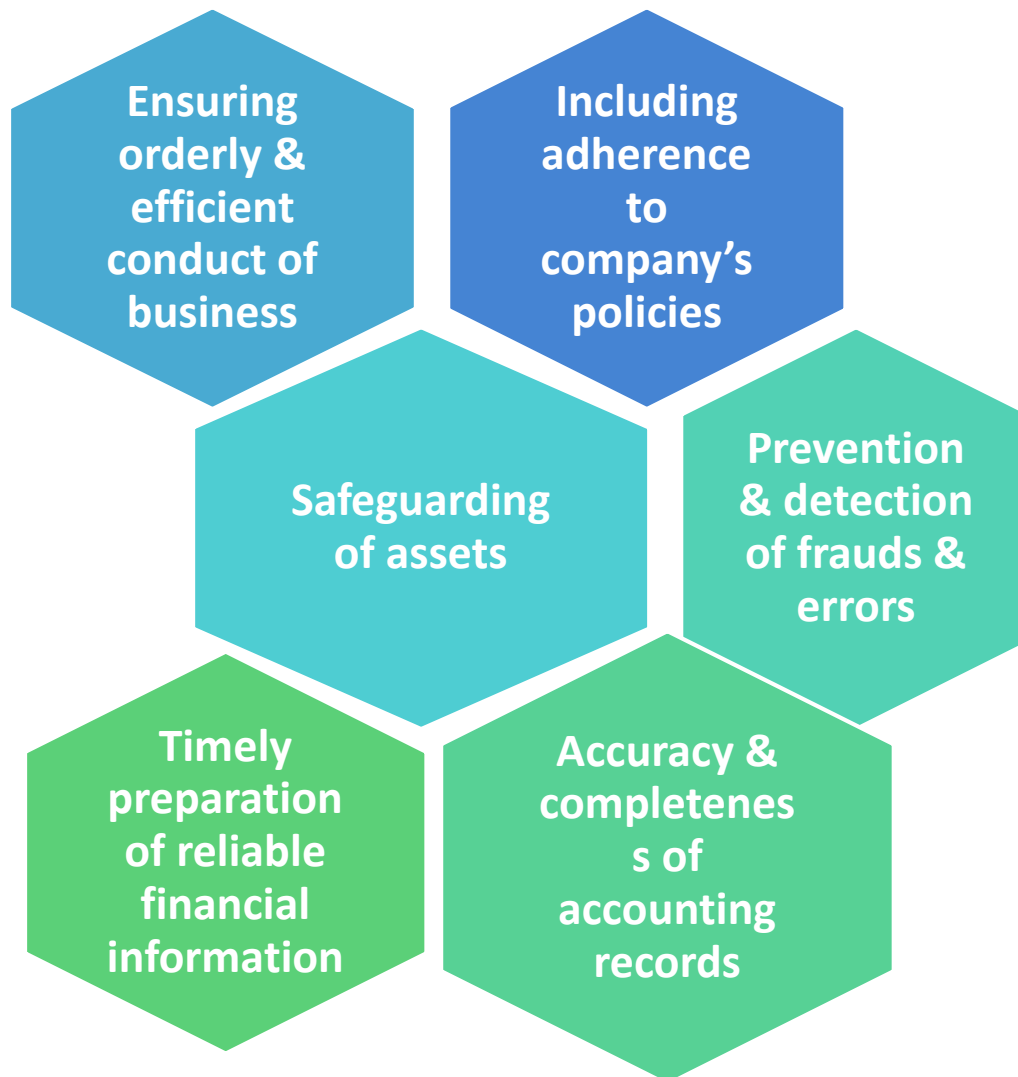
# Advantages of a robust internal financial control system

- Senior Management Accountability
- Improved controls over financial reporting process
- Improved investor confidence in entity's operations and financial reporting process
- Promotes culture of openness and transparency within the entity
- Trickle down of accountability to operational management
- Improvements in Board, Audit Committee and senior management engagement in financial reporting and financial controls
- More accurate, reliable financial statements
- Making audits more comprehensive



# Internal Control Over Financial reporting [ICOFR]

ICOFR means any control which helps in



# Adoption of framework

## **COSO (USA)**

98% of US listed companies use this

## **COCO (CANADA)**

(Criteria of Control) 20 controls in four areas : purpose, commitment, capability monitoring and learning

## **TURNBULL REPORT (UK)**

good internal controls/audits to ensure quality of financial reporting and catch frauds

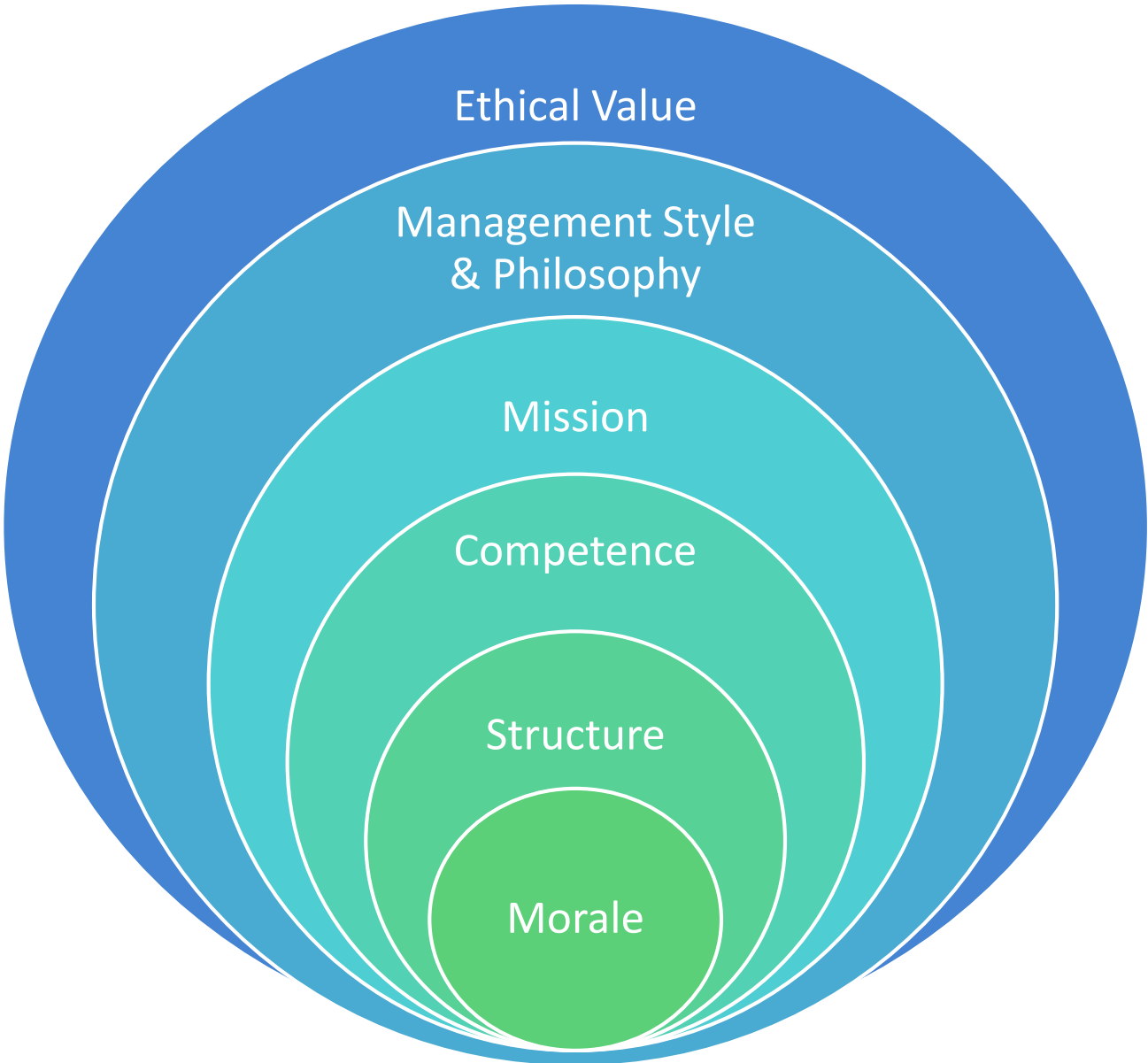
# Essential Components of Internal Controls



# Essential Components of Internal Controls

Component	Principle
<b>Control Environment</b>	<ul style="list-style-type: none"><li>• Demonstrates commitment to integrity and ethical values</li><li>• Exercises oversight responsibility</li><li>• Establishes structure, authority and responsibility</li><li>• Demonstrates commitment to competence</li><li>• Enforces accountability</li></ul>
<b>Risk Assessment</b>	<ul style="list-style-type: none"><li>• Specifies suitable objectives</li><li>• Identifies and analyzes risk (internal/ external)</li><li>• Assesses fraud risk</li><li>• Identifies and analyzes significant change</li><li>• Manage risk (prevent/accept/reduce/ avoid)</li></ul>
<b>Control Activities</b>	<ul style="list-style-type: none"><li>• Selects and develops control activities</li><li>• Selects and develops general controls over technology</li><li>• Deploys through policies and procedures</li></ul>
<b>Information &amp; Communication</b>	<ul style="list-style-type: none"><li>• Uses relevant information</li><li>• Communicates internally</li><li>• Communicates externally</li></ul>
<b>Monitoring Activities</b>	<ul style="list-style-type: none"><li>• Review of activities and transactions</li><li>• Conducts ongoing and/or separate evaluations</li><li>• Evaluates and communicates deficiencies</li></ul>

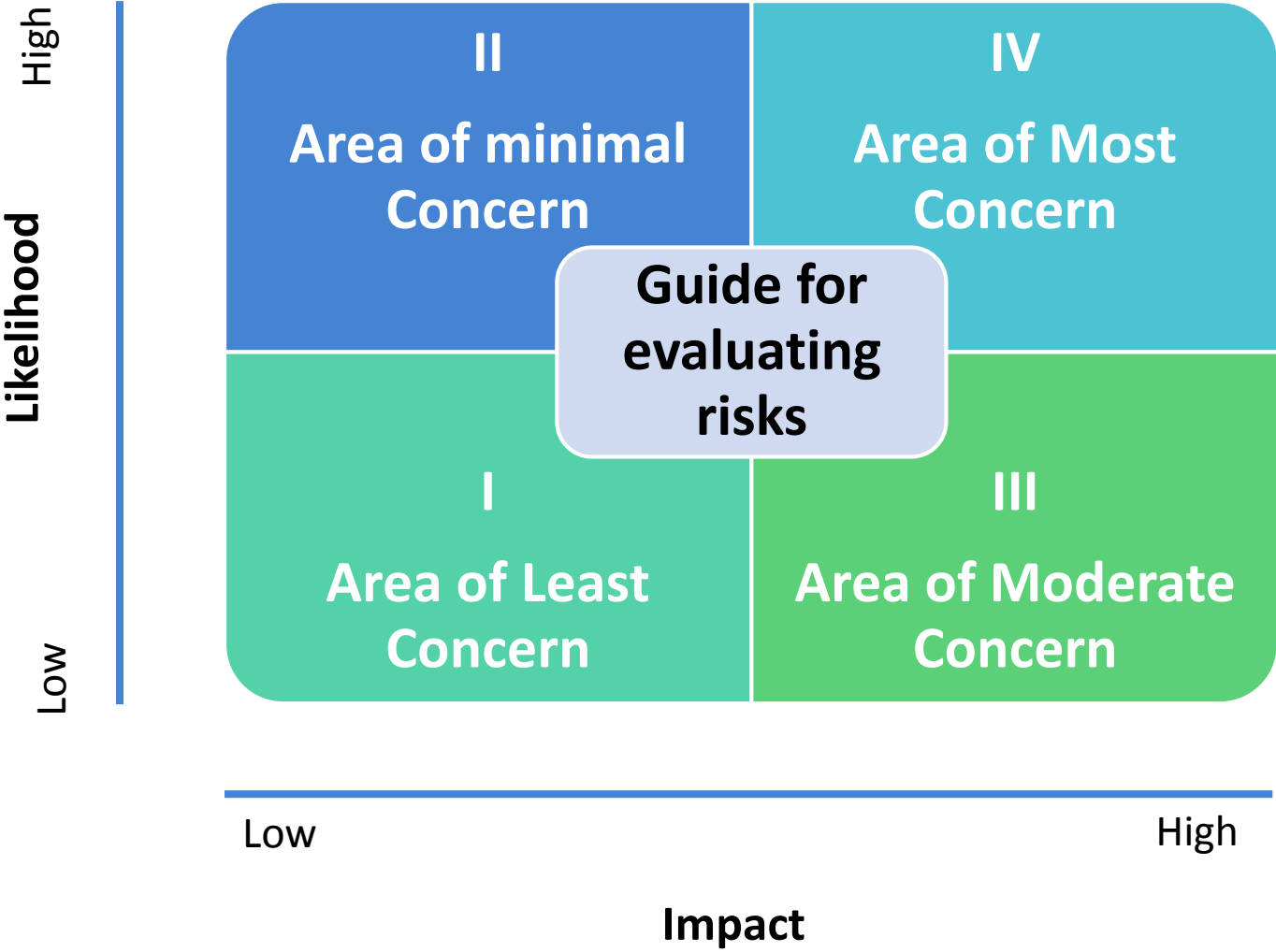
# Control Environment



# Risk Assessment

- Assess and manage Risks
  - **Assess Type of risk**
    - Internal and External Risks
  - **Manage Risks**
    - Prevent risk
    - Accept risk
    - Reduce risks to acceptable risk
    - Avoid risk

# Guide for evaluating risk



# Control Activities

Automated

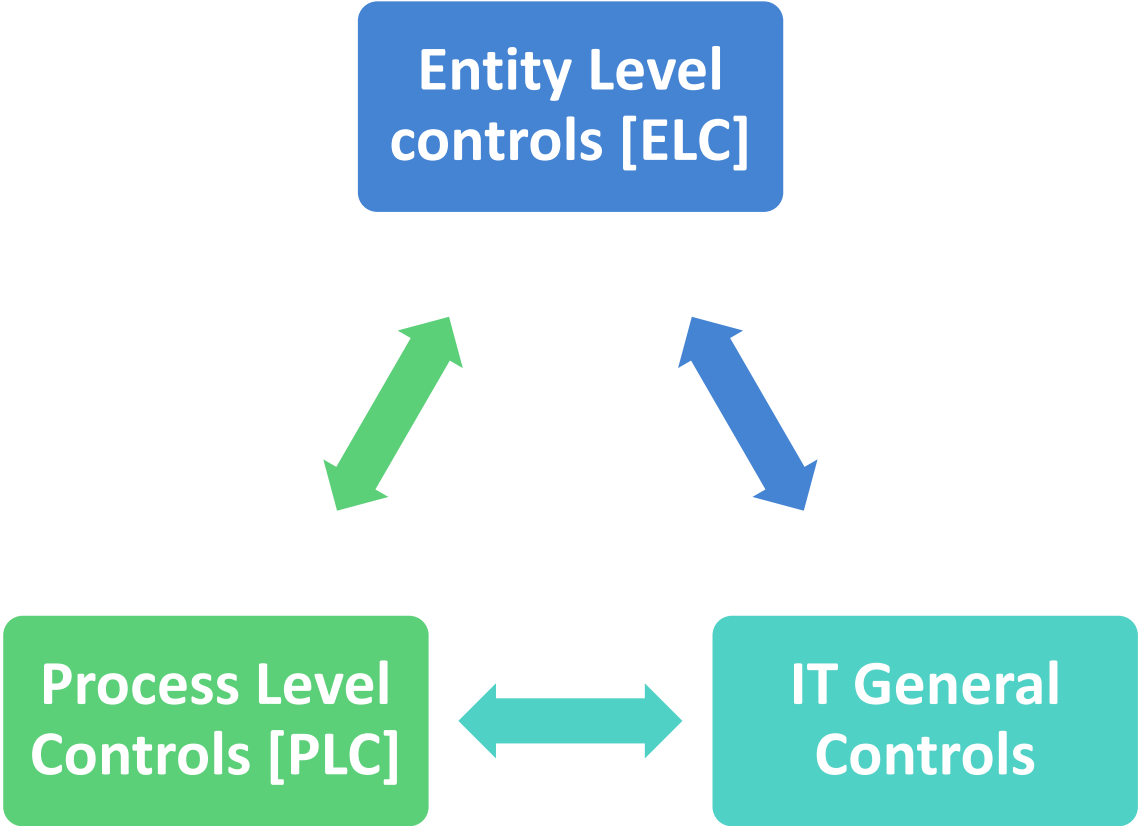
Manual

Preventive

Detective



# Control Activities



# Monitoring

- Monitoring is review of an organization's activities and transactions to assess the quality of performance over time and to determine whether controls are effective
- Major areas:

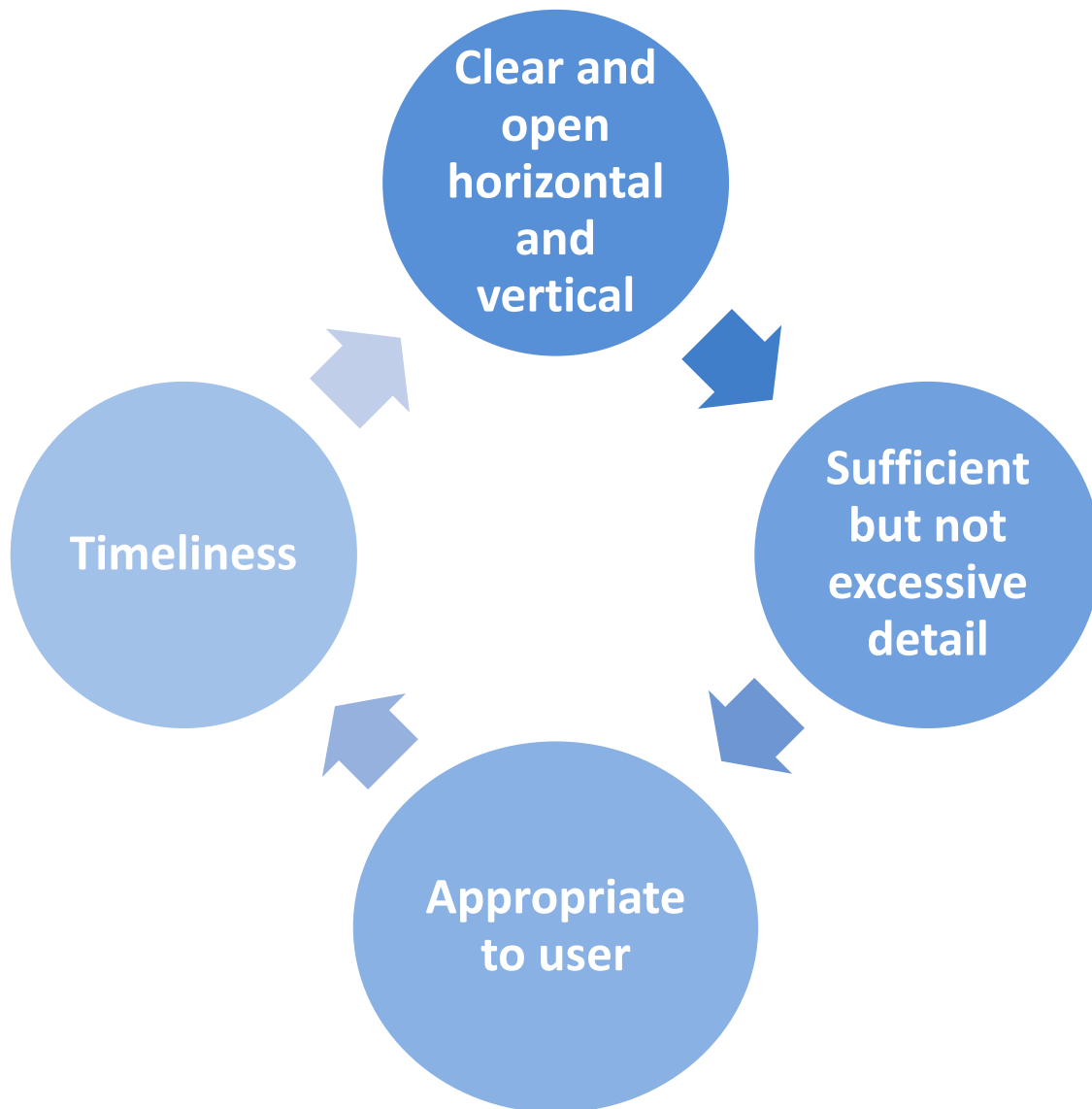


# Examples of control activities

- Documentation
- Approval and authorization
- Verification
- Supervision
- Separation of duties
- Safeguarding of assets
- Reporting
- Information System Controls
  - General IT controls
  - Application Controls
  - Backup and disaster recovery

# Communication

- Elements of communication



# Planning

**Audit strategy**

**Scope, Timing, Direction**

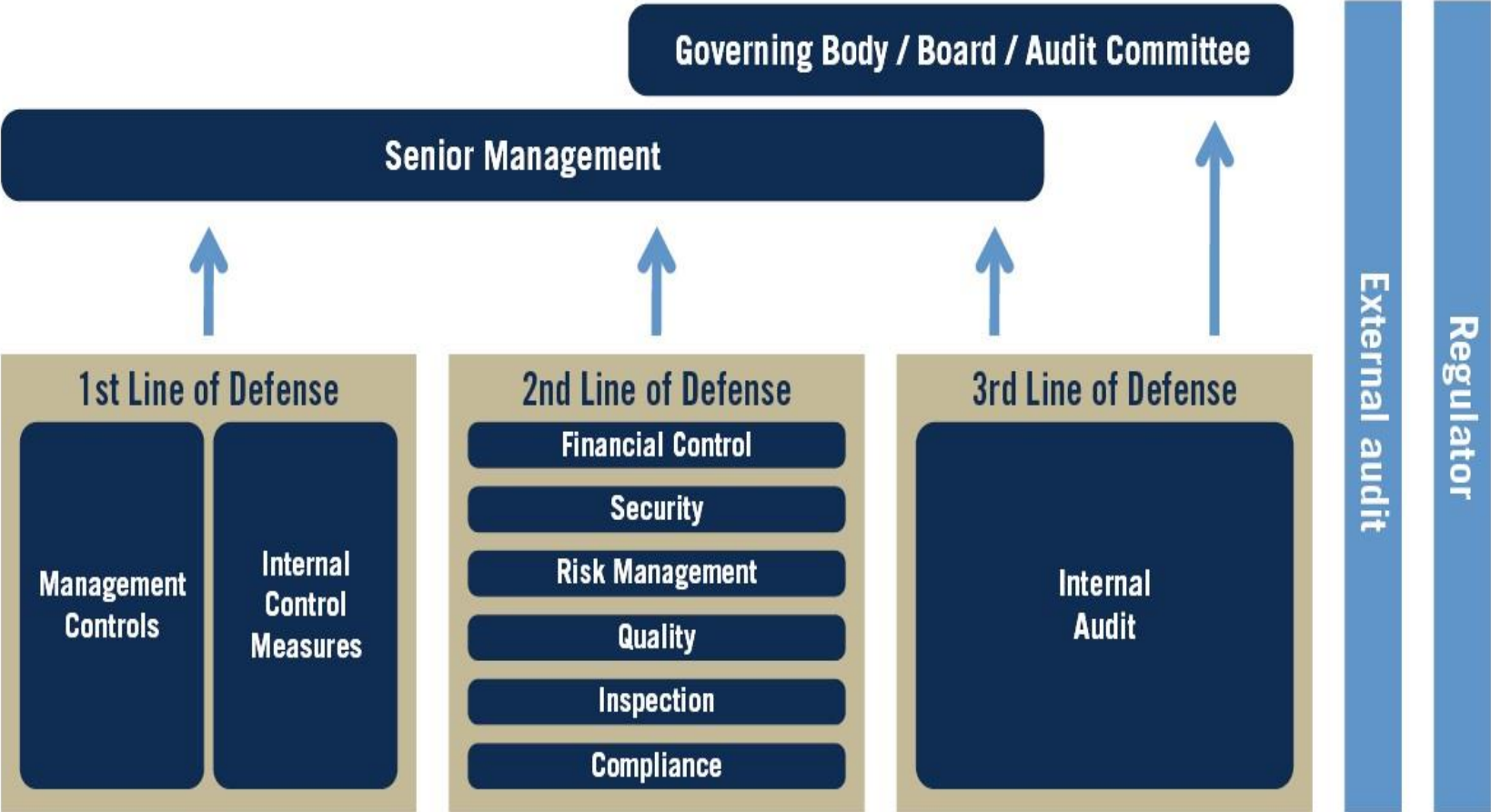
**Identification of significant account balances**

**Identification of risk of material mis-statements**

**Identification and understanding of significant flow of transactions**

**Identification of controls**

# The Three Lines of Defense Model



# Design and implementation

**Testing of Design  
Effectiveness of  
Controls**

```
graph TD; A[Testing of Design Effectiveness of Controls] --- B[satisfy the company's control objectives]; A --- C[can effectively prevent or detect errors or fraud]
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**satisfy the company's  
control objectives**

**can effectively prevent or  
detect errors or fraud**

# Reporting

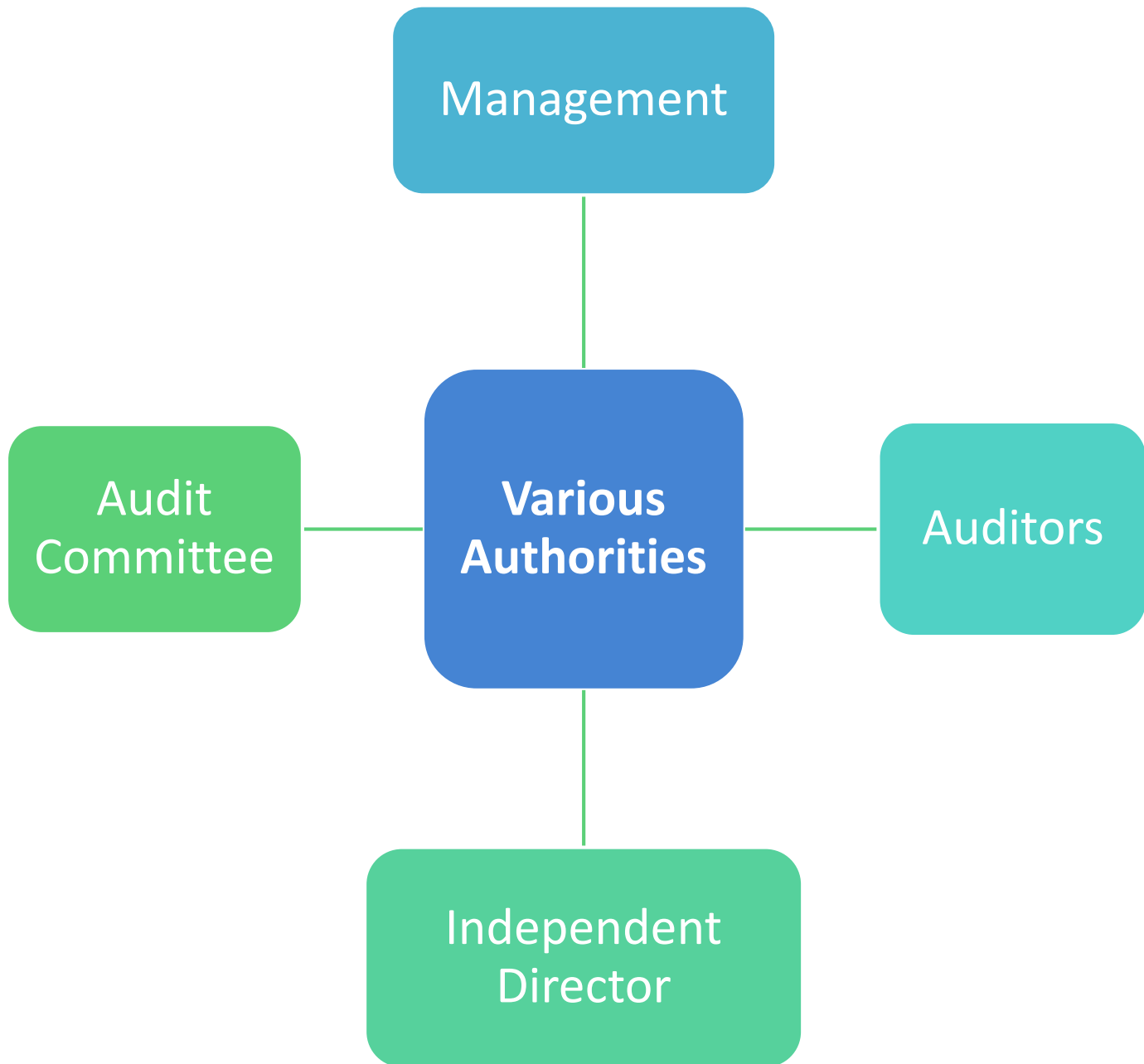
- Reporting not applicable to interim financial statements
- The auditor makes an assessment whether the major weakness noted by him has been corrected by the management
- If weakness not corrected, the auditor should report the fact
- The auditor should report if the company has adequate internal control systems in place and whether they were operating effectively as at the balance sheet date.
- Section 129(4) of the 2013 Act - preparation, adoption and audit of the financial statements of a holding company shall apply to the consolidated financial statements
- The auditor's opinion **does not assure** the future viability of the entity nor the efficiency or effectiveness with which the management conducted the affairs of the entity



# Limitations

- Internal controls are driven by cost benefit analysis
- Frauds and collusions cannot be ruled out however strong the controls
- Internal controls are designed for standard transactions. But innovative products are designed and launched even before systems and processes are put in place
- Management overrule processes while dealing with crisis which then sometimes become a practice. Exceptions become a rule.

# Role of various authorities



# Role of various authorities

## Management

- **LISTED companies**
  - section 134(5)(e) of the Companies Act, 2013- Adequacy and operating effectiveness of internal financial controls
  - Clause 49 IX(C) of Equity Listing Agreement- Certify effectiveness of internal controls over financial reporting
- **ALL companies-** Rule 8(5)(viii) of Companies (Accounts) Rules, 2014 – Adequacy of internal controls over financial reporting

# Auditor

- **Section 143(3)(i)** – report on adequacy of internal financial controls over financial reporting and its operating effectiveness
- **Exception:**
  - One person company or small company
  - Turnover < INR 500 million, or borrowings < INR 250 million



# Independent Directors

- Sec 149(8) read with Schedule IV- Satisfy themselves on integrity of financial information and financial controls
- Ensure that the systems of risk management are robust and defensible



# Audit Committee

- Section 177(4)(vii) - evaluate internal financial controls and risk management systems
- Section 177(5)- call for comments of the auditors on internal control systems, scope of audit, their observations on internal control systems and financial statements



# NBC's Internal Financial Controls Framework

- Entity level
- Process level



# Opportunities for Companies

- Evaluate risks w.r.t. company's size, complexity, global reach, and risk profile
- Companies that choose to do the right thing will **unlock the value, reduce fraud risk, avoid financial reporting surprises, and support sustained business performance** over the long term.





# CORPORATE FRAUDS



# Satyam Computers



# Company Background

- Satyam was established in 1987
- 4th fastest growing IT company in India
- 9 % market share
- 53,000 employees
- Revenue \$2.1 billion
- First Indian company to be listed in three International Exchanges: NYSE, DOW and EURONEXT



# What is the Satyam scam about?

- One of the biggest corporate frauds
- Highlighted the need for better government regulations among corporates
- Scandal broke in 2009
- Ramalinga Raju confessed that the company's accounts were tampered with
- Disclosed INR 7,000-crore accounting fraud in the balance sheets.

# Is this an accounting fraud, a market manipulation/fraud or both?

- It is a fraud, which misled the market and other stakeholders by lying about the company's financial health
- Revenues, operating profits, interest liabilities and cash balances grossly inflated

# How was the Satyam fraud detected?

“I was riding a tiger and did not know how to get off it without being eaten”

- Showed a profit margin of 25%, whereas actually it was 3%
- The accrued interest of US\$ 81.59 million was non – existent
- Understated liability of \$ 266.91 million
- Debtors’ position was overstated to \$ 106.33 million as against 575.27 million in the books
- Cash at hand was shown to be about \$ 1 billion against only \$120 million in reality
- Raju took sole responsibility for fraud

# Who is to blame here?

- The promoters are primary culprits, although it is almost impossible to misrepresent such facts without the connivance of the auditors and some executive board members
- Independent directors, it seems, were kept in the dark about the actual books of accounts

# What about the auditors?

- The role of external third party auditors, who were tasked to ensure that no financial bungling is undertaken to carry out promoters' interest or hide facts, have also been brought to question.







₹7,855cr

Total amount of financial irregularities in Satyam Computer Services scam

7,500

Number of fictitious invoices discovered

₹5,352.8cr

Fictitious revenue reported between April 2002 and September 2008

₹899.8cr

Fictitious interest income recorded from 2002 to 2008

₹206.1cr

Fictitious foreign exchange gain from April 2002 to 2008

500

Number of clients the company had before the scam came to light

45,000

Company's number of employees when the scam came to light in January 2009

32

Number of months Raju has served in prison already

# Anatomy of fraud

## 1. Maintaining records

- Thorough details of the Satyam's accounts and minutes of meetings since 2002
- Records of accounts for the latest year (2008-09) in a computer server called "My Home Hub."



## 2. Fake invoices and bills

- Details of accounts from 2002 till January 7, 2009 –were stored in two separate Internet Protocol (IP) addresses
- Fake invoices and bills were created using software applications such as 'Ontime'
- A secret programme in the source code of the official invoice management system creating a user id 'Super User' with the power to hide or show the invoices in the system



### 3. Web of companies

- **356** investment companies used to allegedly divert funds from Satyam
- Transactions in the form of inter-corporate investments, advances and loans
- One such company, with a paid up capital of Rs 5 lakh, made an investment of Rs 90.25 crore and received unsecured loans of Rs 600 crore



## 4. Why did he need the money?

- Cash used to purchase several thousands of acres of land to ride a booming realty market
- Facts had to be doctored to keep showing healthy profits
- Selling Maytas Infrastructure and Maytas Properties to Satyam for **INR 7,800 crore**
- A big chunk of cash was “fictitious” in balance sheet
- The Acquisition plan rejected by institutional investors
- Raju made stunning confessions and took sole responsibility for fudging accounts

# Reasons for fraud

- Weak corporate governance
- Dubious role of independent directors
- Failure at all 3 levels of auditing - Financial irregularities were ignored by the internal & external auditors – Internal audit headed by the CFO – External audit by PwC – Board’s audit committee headed by independent directors



# Could the fraud be avoided?

- Yes, Ofcourse
- Company lacked internal controls
- Weak Board composition: 9 members, out of 2 were Raju and his brother, 5 independent directors from outside, 1 consultant and 1 employee
- Ignorance on part of Board



# Ricoh India





# Shooting to fame

- A listed company retailing digital printers and imaging equipment
- Forex fluctuations and wafer-thin margins led to the firm reporting losses in FY12
- In 2012-13, shift from hardware retailing to IT services
- ‘Digital India’
- Revenues shooting up from **INR 633 Cr** in FY13 to INR 1638 Cr by FY15
- Losses (INR 1.3 cr) turning into profits (INR 33.9 cr)
- Profit estimates lowered by 10,000 million yen
- Ricoh Company not to provide any additional financial support to the India business
- Accounts appeared to have been “falsified”

# Satyam syndrome

- Reported a net loss of INR **1,117 crore**
- Write-offs completely wiped out its net worth
- The Japanese parent agreed to write off its equity, infuse new capital and promised a quick turnaround
- Bankruptcy resolution

# Reasons for the fraud

- ‘unsupported out-of-book adjustments’ to net sales, expenses, assets and liabilities, converting losses into profits.
- Did not present a “true and fair picture” in 2015-16
- Reported losses of **INR 1,117 cr**
- Crash in share price > 50%
- Recognised product sales without delivery
- Service revenues without completing projects
- forensic audit into Ricoh’s past financials from FY13

# What has changed?

- A rebooted Companies Act (2013) and a new set of SEBI LODR Regulations
- Statutory auditors held office for 15 years
- More than the required quota of independent directors (four out of seven) on its board. They also manned the audit committee
- Inordinate delay in results filings
- Ricoh's bonds actually earned a rating upgrade
- SEBI to now restore some confidence would be to pursue this investigation
- Impose strong penalties on both the internal and external perpetrators of this fraud

# Latest Update

- On January 25, 2018, Ricoh India had filed an application u/10 of IBC, 2016 for insolvency proceedings
- Unable to meet its liabilities
- IBC provided a resolution framework to help corporates clean up Balance Sheets and reduce debts



# Punjab National Bank



# PNB Fraud

- On 14<sup>th</sup> February, 2018, one of India's biggest banks disclosed a **\$1.77 billion fraud** allegedly by one of the country's richest men, **Nirav Modi**
- Who deals in pearls and diamonds



# Nirav Modi saga

- Modi grew up in Antwerp
- Net worth \$1.73 billion
- Modi's ambitious plan to have 100 boutique retail stores worldwide by 2025
- Modi is 85<sup>th</sup> on Forbes's 2017 list of India's richest people and 47<sup>th</sup> for one of the youngest
- Moved to India in 1990
- His store in New York shares space with legendary brands and paid \$1.5 million a year as rental
- Opened stores in London, Hong Kong and Macau as well



# About the case

## Who are the key people involved?

- PNB alleged that fraud was led by Nirav Modi
- Further, Modi worked with a former PNB employee, Gokulnath Shetty who was posted at a PNB branch in Mumbai from where the fraud originated
- Shetty was a deputy GM in forex department



# What is this fraud about?

- Used fake PNB guarantees worth \$1.77 billion
- To obtain loans from the overseas branches of Indian banks
- Claiming to need the cash to import pearls



# How did it allegedly start?

- Started from 2011
- Shetty issued several fake PNB letters of undertaking
- without any collateral (security)
- Bypassed PNB's internal messaging system in order to avoid detection
- Placed instructions via the SWIFT global payment system asking overseas branches of Indian banks to fork out the cash as loans

# How did it come to light?

- When representatives of Modi's companies approached PNB for a fresh loan
- Shetty had retired
- His successor declined to honor Modi's request
- Firms contested that they have been availing this facility in the past also
- But the branch records did not reveal details of any such facility
- Discovered the fake letters of undertaking
- Filed an initial complaint alleging a \$44 million fraud
- Another complaint covering transactions worth about \$1.77 billion

# Who bears the brunt?

- Money was used either to retire import bills or replenish maturing lines of credit with some other banks
- PNB names the Hong Kong branches of Axis Bank Ltd. and Allahabad Bank as the overseas counterparties
- Allahabad Bank has exposure of about INR 40 billion
- Axis Bank has a INR 30 billion exposure
- Union Bank has about INR 20 billion exposure with rest accounted to State Bank of India
- The transactions were undertaken in the normal course of business and credited to PNB's nostro accounts

# Reasons for PNB fraud

- Failure of the most elementary checks and balances in operations
- Total failure of risk management in the bank
- Faltered at various levels in following the basic banking principles of loans and advances
- Full integration and reconciliation of SWIFT transactions not done
- Audit report didn't find it potential risk zone
- Rotation of employees in every three years, not complied
- Unauthorised sharing user IDs and passwords
- One employee used two or at times three officers' passwords
- The maker-verifier-approver chain was not followed in issuing LoUs
- No inter-bank communication was maintained
- Reconciliation and confirmation processes were not followed

# How this fraud could be prevented?

- RBI has constituted an expert panel
- review of critical systems and processes
- Disclosures to RBI, SEBI and other regulators
- adequate systems and controls in place to identify potential risks and being followed at all relevant branches
- SWIFT-CBS linking must be made mandatory for all LoUs
- Confirmation from lending foreign branches for each LoU
- All internal and external audit reports to be shared with Govt. auditors and RBI
- Awareness among bank officials about possible banking frauds
- Use of 'Blockchain' technology for recording all transactions

# How NBC can assist?

- Train Board members on IFC related requirements of the Act
- Establish internal controls framework : both Entity Level Controls and Process Controls
- Benchmark controls against leading practices
- IT controls, prevention vs detection, manual vs automated
- Establish a comprehensive Risk Management Framework and/or targeted intervention in areas such as:
  - Identifying and prioritizing risks that matter
  - Automating the risk monitoring process
  - Defining “value at risk” and/or “risk impact”
  - Monitoring and management of fraud risks



# How NBC can assist?

- Continuous controls monitoring and fraud risk analytics
- Design and implement controls self-assessment
- Design and assist in implementation of delegation of authority, segregation of duties etc.
- Develop standard operating procedures
- Rationalize and automate current controls portfolio
- Design MIS and board reporting framework
- Train employees on their role in the overall internal controls process and on leading practices for managing emerging risks in areas such as IT, fraud, contract compliance etc.

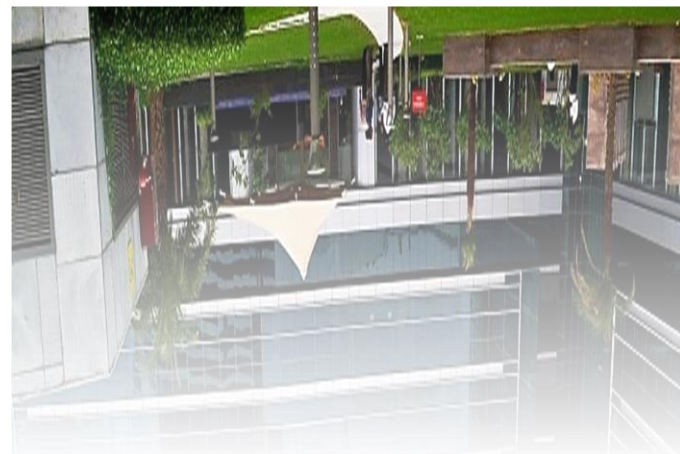
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Our team is mix of experience and youth and working for companies in different industries across the globe. Our team is rendering services in the field of Accounting, Statutory Tax Compliances, FEMA, Transfer Pricing, Statutory Audits and Tax due diligence since last 19 years.

Since 1997, Neeraj Bhagat & Co. is growing on a fast pace and has its own office space in New Delhi, Gurgaon and Mumbai. All the offices are equipped with modern IT and other infrastructure facilities for its employees & clients. We are part of Allinial Global which is one of the World's Top 20 in accounting associations.

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**Thank you !**

