

# Ascertaining frauds from financial statements

SRIDHARAN A M

ADVOCATE

[sridharadv1966@gmail.com](mailto:sridharadv1966@gmail.com)

# Scrutinizing financial statements

- Was easier prior to Feb.2011
- Become difficult after Feb.2011
- Schedule VI under the Companies Act, 1956 was replaced by notification no. S.O.447 (E) dated 28/02/2011 of the Ministry of Corporate Affairs.

# NPAs of SCBs

- NPAs of SCBs increased from Rs.3,23,464 crores as on 31/03/2015 to Rs.10,35,528 crores as on 31/03/2018
- NPAs in public sector banks increased by Rs.6.2 lakh crores between March 2015 and March 2018

# UNDER OLD SCHEDULE VI

- Under Old Schedule VI, manufacturing companies and trading companies were required to give lots of quantitative information
- Licensed capacity
- Installed capacity
- Actual production
- Company in spite of utilizing its installed capacity fully and having minimum inventory still shows loss, then there is definitely mismanagement
- Company which is mismanaged very often changed their financial year

# OLD SCHEDULE VI

- Under the Companies (Report of Board of Directors) Rules, 1988 companies were required to disclose the consumption of electricity for per unit of production
- All these requirements are now done away with
- Now what is required to be disclosed – information in rupee terms. Hence, finding fraud from the financial statements has become a onerous task.

# CORPORATE ANNOUNCEMENTS

- Look for the material information disclosed by the companies under Reg.30 of SEBI LODR Regulations, 2015
- While studying financial statements, please check whether the corporate announcements reflect in the financial statements

# Studying financial statements

- Minimum three years financial statements have to be studied and the financial statements of companies engaged in similar business have to be studied
- Read fully the Directors' Report attached under Sec.134(3) of the Companies Act, 2013 – qualifications some companies merely repeat what auditors say in notes on accounts; 134(3)(f) demands fullest information and explanation
- Management Discussion and Analysis Report;
- Auditors' Report
- Notes on accounts

# Cash Flow Statement

- Cash flow from operating activities;
- Cash flow from investing activities;
- Cash flow from financing activities;



# Cash flow from operating activities - significance

- Positive cash flow operating activities signify the financial health of the Company;
- Vanishing companies – a study would reveal invariably these companies have shown negative cash flow in cash flow from operating activities
- Negative cash flow – recession in the economy – while sales have come down expenditures remained constant

# Cash flow from operating activities

- sales not translating into cash –
- May be Fictitious sales
- Sundry Debtors have come down compared to previous years Balance Sheets – signifies either the sales are cash sales or sales have translated into cash; Still a company shows negative cash flow should be looked into seriously

# Cash flow from operating activities

- may be sales to related parties – AS 18, Compliance with Sec.185, 186, 188 and various rules
- Transactions with related parties could be very huge
- Related parties may reap the benefits;
- Related parties are companies, then their financial statements can be downloaded from the ROC website and can be studied.
- Purchases from related parties could have been done at exorbitant costs
- If costs of sales, is more than 35% to 45% of sales, then certainly purchases are made at higher prices

# Cash flow from operating activities

- If sales made to related parties form major portion of sales, then sales at huge discounted price, the related parties sell the finished products at market price and they make the profit.

# Cash flow from operating activities

- If cost of sales are maintained at 35% to 45% of sales, then also the company is incurring outflow of cash
- Compare the expenditures under each heads for the last 3 years or 5 years, which expenditure has gone up substantially. There could be inflation of expenditure.

# Cash flow statement

- Negative operating cash flow statement invariably implies
- Company should get money from investing activities or financing activities
- Continuous Negative cash flow from operating activities indicate that the winding up of the company is imminent

# Cash flow statement

- Investing activity – negative
- Company invested money in some other companies
- See the details of investments under the heading long term investments or short term investments
- Money invested could be a dead investment or invested in related party companies;
- If the investment is made in related party companies, their financial statements shall be downloaded from Ministry website and shall be studied

# Cash flow from financing activity

- Outflow - redemption of debentures or preference shares, repayment of loans.
- Inflow obtaining fresh loans, raising equity or preference or issuing debentures
- If during a particular year, shares allotted then the same should reflect in the financing activity.
- In a company making continuously losses, if the promoters infuse further equity, there is every possibility that they may plough back part of the siphoned off funds.
- Per contra, shares are allotted and the consideration is not reflected as inflow of cash, shares could have been allotted for consideration other than cash or there could be some manipulation on allotment of shares.
- Loans coming down but interests costs going up



# Cash flow from financing activity

- During the year of public issue, if the issue is fully subscribed and in the financial statements, if the long term loans and advances or short terms loans and advances have gone up substantially, then the issue itself could have been financed.

# Bank Reconciliation statement

- Scrutiny last six months reconciliation statement
- If any transaction is continuously shown then such transaction should be further enquired

# Reserves & Surplus

- Employee stock option Reserve
- Cost amortized through Profit & loss account shall be credited to profit & loss account in case the option is not vested in the hands of the employee due to some or other reason.
- SEBI (ESOS and ESOP) Rules and Accounting Standard for employee benefits and Guidance Note issued by the ICAI

# Composite issues

- Public issue of shares
- Offer for sale of shares
- Issue expenses – wholly passed on the Company
- Companies which have come out with public issues Technical scrutiny done by analysing the prospectus and Balance Sheets;

# Foreign exchange outgo and inflow

- One has to study, whether the income derived from overseas sales, justify the incurring of foreign exchange outgo.

Thank you

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