

Fraud Detection Through Secretarial Audit

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Definition

- Section 447- “ fraud” in relation to affairs of a company or any body corporate includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner with intent to deceive, to gain undue advantage from or to injure the interest of the company or its shareholders or its creditors or any other person whether or not there is any wrongful gain or loss

INGREDIANTS

- Any act, omission, concealment of fact or abuse of position
- Committed by any person or with connivance in any manner
- With intention to deceive, gain undue advantage or injure interest of a) shareholder, b) creditor, c) company, d) any other person (***wrongful gain or loss need not be present***)

SECRETARIAL AUDIT

STATUTORY-- Section 204

- a) Every listed company
- b) Every public company with PUC Rs 50 crore or more
- c) Every public company having turnover Rs. 250 crore or more

Continued

- Non- statutory-
- Following activities imply secretarial audit to be done, though not expressly stated in the Act:-
 - A – Certification of e-forms
 - B– Search Reports
 - C – Compliance certificates
 - D – Any other reports or certification

MAGNITUDE OF FRAUD

- Global survey reveals – fraud found in every one in three companies- about 37% of the companies experience fraud. Areas of fraud:-
 - A) Asset misappropriation (69%)
 - B) Procurement fraud
 - C) Bribery & corruption
 - D) Cyber crime
 - E) Accounting fraud (22%)

AREAS OF FRAUD

- RPT :-
- A) Poly Pack - British Textile company – diverted funds to related companies through 88 separate deals, mostly companies owned by his son and relatives - led to enactment of the Code of Corporate Governance in UK
- B) HIH – Australia’s second largest health insurance company. Rodney Adler made the company to invest 2 million pounds in his own company BTS without disclosing his interest

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- C) Lehman Brothers – One of the largest global financial services company in USA – Attempted to show rosy financial statements through a series of re-purchase contracts with related parties at artificial price
- D) Adelphia communication corporation (USA) – CEO John and Timothy Rigases diverted funds to their family owned businesses through complicated cash management systems involving \$2.3 billion

CONTINUED

- E) Britania Industries Limited – MD and CEO Rajan Pillai, biscuit tycoon diverted benefits to a firm in which his wife was the major partner without disclosing his interest to the BOD
- F) Satyam computer services –MD and CEO Ramalinga Raju put through RPT transactions to the tune of \$ 1.6 billion to Maytas Properties and Maytas Infrastructure, companies predominantly owned and managed by his sons

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- G) UB Group – It is alleged as seen from journals/newspapers that Vijay Malya has been indirectly benefitted to the extent of several crores through certain RPT transaction in the form of acquisitions and divestment
- H) Wipro – similar allegations have been made regarding certain brand valuation in mergers/demergers to benefit Azim Premji family.

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- Delhi High court observed in *Globe Motors Limited v Mehta Teja Singh & Company* that “***although an agreement in which a director was interested could not be invalid in view of compliance with the requirements of the Act, yet it is only a formal aspect of compliance, the basic question is the conduct of the directors and whether it satisfies the test considering their fiduciary relationship with the company...***”

EXCESSIVE CEO COMPENSATION

- A) Tyco – (USA) – CEO Dennis drew \$600 million excess compensation and spent \$2 million on his wife's birthday party at company's expense
- B) Global Crossings - Four CEO's drew \$23 million each from the company and later removed such liabilities through write of driving the company to bankruptcy

CONTINUED

- C) Fannie Mae – CEO took \$115 million in bonus payment by inflating profits and suppressing losses.
- ***Schedule IV of the Act read with sections 197/198 of the Act deal with CEO compensation. One needs to scrutinize records to find out withdrawal of funds from company by any means***

INSIDER TRADING

- A) ENRON – Largest American energy company. Fortune-100 named ENRON “America’s Most Innovative Company” for six consecutive years. Kenneth Lay CEO and his wife Linda sold all the shares held by them in the company worth \$ 90 million @ \$ 90 per share. After CEO’s wife completed sale of all shares between 10 am and 10.20 am, share price crashed less than a dollar around 10.30 am due to announcement of filing under chapter 11 for bankruptcy

CONTINUED

- B) Health South – Health care company in USA. CEO sold \$ 100 million worth stock before the company reported huge losses.
- B) Galleon – Raj Rajarathnam obtained inside information from Rajath Gupta, a member of the Board of Goldman Sachs that Warren Buffet's Berkshire Hathaway was going to make a crucial investment in Goldman Sachs. Raj Rajarathnam was convicted to pay fine \$ 92.8 million and sentenced to 11 years imprisonment

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- In India also there are many convictions brought through action of SEBI.
- Section 195 prohibits the Directors and KMP from carrying out any Insider Trading activity and provides for penalty of rupees 25 crore or 5 years imprisonment or both

FRAUDULENT MOBILISATION OF FUNDS

- Southern Herbals Ltd – Prospectus announced production of anti-cancer drugs and assured 100% buy back arrangement with a german company. None of these were true
- Vanishing Companies – MCA identified 229 such companies which mobilized more than rupees 3000 crores.
- Harshad Mehta – Estimated to have mobilized about rupees 120000 crores in security transactions with Banks

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- Sahara scam – SEBI's sustained efforts brought to book the promoter and ensured return of money to investors.
- New Companies Act 2013 has several stringent provisions regarding mobilization of funds either through private placement or public issue of securities or public deposits

PONZY SCHEMES

- Speak Asia – 24 million Indians cheated to the tune of rupees 2200 crores. Induced investors to submit online survey form to earn rupees 52000 per year. Additional commission for introducing new members. There was no end users for survey reports.
- Saradha Chit Funds – The scam has established political – corporate nexus at the cost of gullible investors

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- Bernie Madoff – Promised assured return of over 15%. Mobilized \$ 65 billion. Scam exposed by own family members. Imposed penalty and sentenced to stay in prison till end of life
- ***New Companies Act 2013 has stringent provisions regarding mobilization of funds through private placement or public issue of securities or public deposits***

ASSET STRIPPING

- May be carried out by moving assets to other companies with the intention to put the main company under liquidation or the asset of the acquired company may be stripped to recover the cost of acquisition
- Penta Media – Involved in Ketan Parek scam when the share price was boosted to Rs.2130. Assets worth \$ 30 million disappeared from the books which were systematically moved to Mayajal Entertainment and other companies. The intention being to put the main company into bankruptcy

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- Phone 4U – BC partners, private equity firm acquired the company and put in only 200 million pounds of its own cash. Borrowed 205 million pounds from City Lenders and paid itself dividend of 223 million pounds and later the company went into bankruptcy
- Transworld Airlines – American airline – After acquisition the company went into bankruptcy

MARKET MANIPULATION

- Grow More Group of companies (Harshad Mehta)
- Ketan Parek Group of companies (Manipulation of K10 scrips)
- Fair growth Financial services (company of former chairman of Canara Bank – Ratnaker)
- Barclays Bank – involved in rigging LIBOR rate

POLITICAL-CORPORATE NEXES

- 2G scam
- Coal scam
- Sarada chit funds

ACCOUNTING FRAUD

- ENRON
- WORLDCOM
- PARAMALET SPA – Italian company
- HEALTH SOUTH
- Satyam Computer Services
- Grow more Group of companies
- Fair growth Financial Services

FORM – MR 3

- Format prescribed by MCA for preparing Secretarial Audit Report for specified companies

THE CHALLENGE

- As a Practicing Company Secretary, how would you respond when fraud is detected during secretarial audit?
- Section 204 mandates that the Secretarial Audit Report should be annexed to Board's report made u/s 134 –Directors have to explain every adverse remark or qualification in their report
- Penalty for non-compliance –Fine not less than rupees one lakh and not more than 5 lakhs

• THANK



YOU